Chapter 4: Selected Real Estate Topics

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Please note. Corrections were made to this workbook through January of 2020. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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PASSIVE LOSS RULES

The passive loss rules can have a substantial impact on taxpayers. Before 1987, it was commonplace for investors in real estate to incur losses on an investment and use the losses to offset the investor's wage or other income. In 1986, Congress enacted the passive loss rules intending to limit (or eliminate) such deductions.[1] Those rules reduce the possibility of offsetting passive losses against active income unless the taxpayer can demonstrate that they materially participate in the activity.

THE BASIC CONCEPT

The passive loss rules apply to activities involving the conduct of a trade or business when the taxpayer does not materially participate in the activity on a regular, continuous, and substantial basis or in a rental activity (regardless of the level of participation, except as provided in IRC §469(c)(7)).[2] If the passive loss rules apply, deductions from passive trade or business activities, to the extent the deductions exceed income from all passive activities, may not be deducted against other income. The losses can only offset income from a passive activity.

MATERIAL PARTICIPATION

Unless an investor or other individual can meet the material participation test, the passive loss rules apply. There is an "active participation" exception to the requirement of material participation for taxpayers with rental activities who are not real estate professionals (discussed later).

If the taxpayer satisfies the material participation test, then passive losses can be deducted against active income. An investor is treated as materially participating in an activity only if the person "is involved in the operation of the activity on a basis which is **regular, continuous, and substantial.**"[3]

Example 1. Dr. Pepper is a physician who also materially participates in a consulting activity. Dr. Pepper can use the losses from his consulting activity as a deduction against his income from the practice of medicine.

Satisfying Material Participation

In February 1988, the IRS issued temporary regulations specifying the requirements for the material participation test.[4] These regulations apply to any taxpayer dealing with potential passive activity losses, (including, e.g., a physician, veterinarian, lawyer, or any other nonfarm investor who leases agricultural real estate to another party for farming activities).

The temporary regulations identify seven tests for material participation. **Any of the seven tests can be used for purposes of satisfying the material participation requirement.**[5]

Observation. For an individual who holds an interest in a trade or business through a limited partnership, the only tests that can be used to satisfy the material participation requirement are the 500-hour test and the facts and circumstances test (discussed below). For this purpose, an LLC interest is not treated as a limited partnership interest.

1. IRC §469.
2. IRC §469(h)(1).
3. Ibid.
4. Temp. Treas. Reg. §1.469-5T.
5. See, e.g., *Garnett v. Comm'r,* 132 TC 368 (2009); *Thompson v. Comm'r,* 87 Fed. Cl. 728 (2009).

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1. **500 hours.** Under this test, an individual is considered to materially participate if the individual participates in the activity for more than 500 hours during the year.[6] This is a substantial amount of time — almost 10 hours per week. As a result, this test may be difficult for some investors to satisfy.

2. **Substantially all participation.** This test involves situations in which an individual's participation is less than 500 hours but constitutes substantially all participation in the activity by all individuals during the year.[7] For example, if the investor participates less than 500 hours annually in the activity but substantially all of the participation comes from the investor, the investor satisfies this test.

Note. It is not likely that an investor can meet this test (or the next test) if another party operates the activity. The other party likely will devote more time to the activity than the investor.

3. **100 hours.** Material participation rules can be met if the individual participates more than 100 hours per year in the activity and their participation is not less than any other individual.[8]

4. **Significant participation.** An individual is treated as materially participating in significant-participation activities if their aggregate participation activities for the year exceed 500 hours.[9] A "significant-participation activity" is a trade or business activity in which the individual participates for more than 100 hours for the tax year.

Example 2. Mike owns a convenience store, two fast food restaurants, and a farm. If Mike participates more than 100 hours (but less than 500) in each activity, he can aggregate the hours to determine if he satisfies the significant-participation test.

5. **Prior 10 years.** Under this test, the individual is treated as materially participating if they materially participated in the activity for any five of the 10 tax years immediately preceding the tax year at issue.[10]

Note. The idea behind this rule is that substantial involvement over a lengthy period may indicate the activity was the individual's principal livelihood. This is a very useful test for a retired taxpayer who had several years of involvement.

6. **Personal service activities.** A taxpayer is treated as materially participating in a personal service activity for a tax year if they materially participated in the activity for any three tax years preceding the tax year in question.[11] **Personal service activities** include accounting, law, medicine, and other professional services.

7. **Facts and circumstances.** The "facts and circumstances" test is the one most investors try to employ. It requires that the taxpayer participate in the activity during the tax year on a basis that is regular, continuous, and substantial.[12] This test cannot be satisfied unless the taxpayer participates more than 100 hours in the activity during the year.[13]

6. Temp. Treas. Reg. §1.469-5T(a)(1).
7. Temp. Treas. Reg. §1.469-5T(a)(2).
8. Temp. Treas. Reg. §1.469-5T(a)(3).
9. Temp. Treas. Reg. §1.469-5T(a)(4).
10. Temp. Treas. Reg. §1.469-5T(a)(5).
11. Temp. Treas. Reg. §1.469-5T(a)(6).
12. Temp. Treas. Reg. §1.469-5T(a)(7).
13. Temp. Treas. Reg. §1.469-5T(b)(2)(iii).

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A taxpayer's activity for any other purpose, such as material participation for self-employment tax purposes,[14] does not count for purposes of the material participation test.[15] What counts is the number of hours the taxpayer is directly involved in the daily management of the trade or business.[16] As noted earlier, if the taxpayer is represented by a paid manager, the taxpayer's own record of involvement does not count.[17]

For purposes of the real estate professional exception (discussed later), hours spent as an employee do not count unless the employee is at least a 5% owner of the employer.[18]

Observation. Accurate and complete books and records are critical to establishing material participation. Lack of substantiation is a leading cause of a taxpayer's failure to establish material participation. Although any reasonable means of documenting participation in an activity is permissible, contemporaneously prepared logs, time reports, appointment books, calendars, and narrative summaries should be used. The Tax Court in two recent cases found material participation present without referring to the taxpayer's documentation of involvement, but the taxpayer clearly put more than 100 hours into the activity. The facts showed that the taxpayer was involved in the activity on a basis that was regular, continuous, and substantial.[19]

Activity of a Spouse or Agent

In determining whether an **individual** taxpayer materially participates (or actively participates), the participation of the taxpayer's spouse is taken into account, **regardless of whether they file a joint income tax return.** While the statute refers to material participation by the **taxpayer,** it does not specifically prevent including the services of an agent. The regulations and court decisions indicate the activities of an agent are **not** attributed to an individual taxpayer, and the individual must **personally perform** sufficient services to establish material participation. An individual's own participation is **not** taken into account if a paid manager participates in the activity and someone else performs services in connection with management of the activity that exceed the amount of services performed by the taxpayer.[20]

Rental Activities

A rental activity is a passive activity by definition, even if a taxpayer materially participates in the activity. However, this does not apply to a taxpayer who:

1. Is a real estate professional, and
2. Materially participates in the activity.[21]

14. IRC §1402.
15. Temp. Treas. Reg. §1.469-5T(b)(2)(i).
16. Temp. Treas. Reg. §1.469-5T(f)(2)(ii).
17. Temp. Treas. Reg. §1.469-5T(b)(2)(ii)(A).
18. IRC §469(c)(7)(D).
19. *Wade v. Comm'r,* TC Memo 2014-169 (Aug. 20, 2014); *Barbara v. Comm'r,* TC Memo 2019-50 (May 13, 2019).
20. Temp. Treas. Reg. §1.469-5T(a); *Robison v. Comm'r,* TC Memo 2018-88 (June 19, 2018).
21. IRC §469(c)(7).

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In addition, an activity involving the use of tangible property is not a rental activity for a tax year under any of the following conditions.[22]

1. The average period of customer use is:
   a. 7 days or less, or
   b. 30 days or less and significant personal services are provided.
2. Extraordinary personal services are provided by or on behalf of the owner.
3. Rental of the property is incidental to a nonrental activity.
4. The property is customarily made available during defined business hours for nonexclusive use by customers.
5. The taxpayer provides property for use in a nonrental activity that is conducted by an S corporation, partnership, or a joint venture in which the taxpayer owns an interest in the S corporation, partnership, or joint venture.

If an activity meets any of these five conditions, it is not passive. It must then be determined whether the taxpayer's rental of the property is a trade or business activity.[23]

$25,000 Exception for Rental Activities. As mentioned earlier, an activity may be considered passive if the taxpayer does not meet one of the material participation rules. Rental real estate is considered passive even if the taxpayer **does** materially participate (except for real estate professionals), and therefore losses from the rental activity are normally not deductible against nonpassive income.

There is an exception to this rule. A taxpayer who is **not** a real estate professional can satisfy the material participation test if:

- The taxpayer **actively participates** (i.e., participates in management decisions in a significant and bona fide sense); **or**
- The taxpayer (and spouse, if any) owns at least 10% of the value of all interests in the rental activity throughout the tax year; **and**
- The taxpayer is not a corporation.[24]

Active participation requires less involvement than **material** participation. Once the taxpayer meets this standard, they can deduct up to $25,000 each year in losses from a rental real estate activity. Losses in excess of $25,000 are suspended until a future year when the taxpayer has sufficient passive income or completely disposes of the activity.[25]

The active participation test is **unavailable** to taxpayers with modified adjusted gross income (MAGI) in excess of $150,000. When MAGI exceeds $100,000, the $25,000 maximum deduction is phased out over a $50,000 adjusted gross income (AGI) range (determined without regard to passive activity losses).

22. Temp. Treas. Reg. §1.469-1T(e)(3).

23. Treas. Reg. §1.469-4(b).

24. IRC §469(i).

25. IRC §469(g).

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MAGI for this purpose is the taxpayer's AGI **without taking into account the following items.**[26]

- Taxable social security and tier I railroad retirement benefits
- Deductible contributions to IRAs and IRC §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 on Form 8582, *Passive Activity Loss Limitations*
- Any rental real estate loss allowed due to material participation in a rental activity as a real estate professional
- Any overall loss from a publicly traded partnership
- The deduction for half of the self-employment tax
- The allowed deduction for interest on students loans
- The allowed deduction for qualified tuition and related expenses (before 2018)

Other Rules

The material participation test is met by a surviving spouse who inherits qualified real property from a deceased spouse if the surviving spouse engages in "active management."[27]

C corporations are treated as materially participating in an activity if one or more of the shareholders who own more than 50% of the outstanding corporate stock materially participates.[28]

Estates and trusts (except for grantor trusts) are treated as materially participating (or as actively participating) if a **fiduciary** meets the participation test.[29]

Observation. Many taxpayers seek to avoid having passive losses that are not currently tax deductible. Other than materially participating as described earlier, there may be an incentive for a taxpayer to be involved in an activity that generates passive income, which could then be offset by passive losses from another activity. Indeed, when the passive loss rules became law, there was immediate interest in creating what came to be known as passive income generators (PIGs). These are investment activities that provide passive income, allowing the investor to match the passive income from the activity against passive losses. Individuals may wish to seek investment advice to acquire PIGs to offset their passive activity losses.

26. IRS Pub. 925, *Passive Activity and At-Risk Rules.*
27. IRC §2032A(b)(5)(A).
28. Temp. Treas. Reg. §1.469-1T(g)(3)(i)(A).
29. See, e.g., *Mattie K. Carter Trust v. U.S.,* 256 F. Supp. 2d 536 (N.D. Tex. 2003); *Aragona Trust v. Comm'r,* 142 TC 165 (2014).

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BARE LAND LEASES

A recharacterization rule applies to bare land leases.[30] Under this recharacterization rule, net income from a rental activity is considered **not** from a passive activity if less than 30% of the unadjusted basis of the property is depreciable.[31] The rule converts both net rental income and any gain on disposition from passive income to nonpassive income. However, the recharacterization rule only applies if there is net income from the rental activity. If there is a loss, the loss remains passive.

Example 3. Dr. Sawbones owns interests in multiple limited partnerships that have suspended passive losses. In an attempt to use those losses, Dr. Sawbones bought farmland for $400,000. Of this amount, $100,000 was allocated to fences, tile lines, grain bins and other depreciable property. Dr. Sawbones cash leased the land to his cousin via a cash rent lease to generate passive income that he could use to offset his suspended passive losses. However, because only 25% of the unadjusted basis of the farming investment is attributable to depreciable property, the cash rent income is recharacterized (for passive loss rule purposes) as nonpassive income and cannot offset the suspended passive losses from the limited partnerships. If the cash rent produced a net loss after taxes, interest, and depreciation, it would be a passive loss. This is not the result that Dr. Sawbones was hoping to achieve.

The facts in this example are similar to those in a 1995 Tax Court decision in which the court upheld the IRS's recharacterization of the taxpayer's income from a land lease as nonpassive.[32]

REAL ESTATE PROFESSIONALS

While a rental activity is defined as a passive activity,[33] if the taxpayer is deemed to be a "real estate professional," the rental activity is no longer considered a passive activity. If the real estate professional materially participates in the rental activity, the activity is treated as nonpassive.[34]

> **Observation.** The rule defining rental activities as passive activities is also a concern because of the net investment income tax (NIIT).[35] The NIIT imposes an additional tax of 3.8% on passive income, including passive rental income. However, the rents are not passive (and not subject to the NIIT) if the taxpayer is a qualifying real estate professional and the income is derived in the ordinary conduct of a trade or business in which the taxpayer materially participates.

Legislative History

As originally enacted, the passive activity definition included **any** rental activity **regardless** of the taxpayer's degree of participation. This barred rental activities from being used to shelter the taxpayer's income from other trade or business activity. Rental activities could often produce a tax loss (particularly due to depreciation deductions) while the underlying property simultaneously appreciated in value. The rule was especially harsh on real estate developers with multiple development projects. In the situation in which a developer developed and sold one property while renting out another project, there were two activities: one trade or business activity (nonpassive) and one rental activity (passive). Any loss from the passive activity was carried forward until the taxpayer either generated passive income or disposed of the rental property in a fully taxable transaction.[36] This produced a different result than could be achieved by taxpayers in non-real estate trades or businesses.

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30. Temp. Treas. Reg. §1.469-2T(f)(3).
31. Ibid.
32. See, e.g., *Wiseman v. Comm'r,* TC Memo 1995-203 (May 10, 1995).
33. IRC §469(c)(2).
34. IRC §469(c)(7). Qualification as a real estate professional is not elective.
35. IRC §1411.
36. IRC §§469(b) and (g).

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To address this perceived inequity, Congress amended the passive loss rules in 1993[37] to provide a narrow exception to the blanket categorization of rental activities as passive. Under the exception, a **real estate professional** materially participating in a rental activity is not engaged in a passive activity.[38] Thus, rental activities remain passive activities unless the taxpayer satisfies the requirements to be a real estate professional. A real estate professional with rental losses can use the losses without limitation to offset income if the taxpayer materially participates in the real estate activities.

Qualifying as a Real Estate Professional

To be a real estate professional, a taxpayer must satisfy both of the following tests.[39]

1. More than 50% of the personal services the taxpayer performs in **all** trades or business for the tax year must be performed in real property trades or businesses in which the taxpayer materially participates.
2. The taxpayer performs more than 750 hours of service during the tax year in real property trades or businesses in which the taxpayer materially participates.

Observation. It is likely very difficult for a taxpayer with a full-time job outside of real property trades or businesses to satisfy the tests, particularly the 50% test.[40]

Two key points concerning the tests must be kept in mind.

- Only the hours a taxpayer spends in real property trades or businesses in which the taxpayer materially participates count towards the two tests.
- If the taxpayer satisfies the two tests, the rental activity is no longer presumed to be passive and, **if the taxpayer materially participates,** the rental activity is nonpassive.[41]

Note. A taxpayer must meet the real estate professional rules each year to be treated as a real estate professional.[42]

For taxpayers with multiple real property trades or businesses, various steps are required to determine if the taxpayer is a real estate professional.

1. Identify and group the taxpayer's various real property trades or businesses activities.
2. Once the taxpayer's various real property trade or business activities are identified, determine in which activities the taxpayer materially participates (under one of the seven tests identified earlier).
3. Add together the hours of the taxpayer's participation in the combined real property trades or businesses in which the taxpayer materially participates. These total hours of participation are applied in determining whether the taxpayer has spent more than 50% of their total time for the year in all activities (passive and nonpassive) in the combined real property trades or businesses and whether that amounts to more than 750 hours. If **both** of these requirements are satisfied, the taxpayer qualifies as a real estate professional.[43]

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37. PL 103-66.

38. IRC §469(c)(7).

39. IRC §469(c)(7)(B).

40. See, e.g., *Hassanipour v. Comm'r,* TC Memo 2013-88 (Apr. 2, 2013); *Escalante v. Comm'r,* TC Summ. Op. 2015-47 (Aug. 10, 2015); *Lee v. Comm'r,* TC Memo 2006-193 (Sep. 11, 2006); *Miller v. Comm'r,* TC Memo 2011-219 (Sep. 8, 2011).

41. IRC §469(c)(7)(A)(i).

42. See, e.g., *Bailey v. Comm'r,* TC Memo 2001-296 (Nov. 7, 2001).

43. Good recordkeeping is imperative to substantiate satisfaction of these tests. Hours spent "on-call" for tenants do not count toward the 750-hour test unless services are actually performed during the on-call hours. See *Moss v. Comm'r,* 135 TC 365 (2010). On the substantiation issue, see also *Harnett v. Comm'r,* TC Memo 2011-191 (Aug. 11, 2011), *aff'd* 496 Fed. Appx. 963 (11th Cir. 2012); *Leyh v. Comm'r,* TC Summ. Op. 2015-27 (Apr. 13, 2014).

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Note. Married spouses filing a joint return can both be considered qualifying taxpayers if only one of the spouses satisfies the two tests for real estate professional status under §469(c)(7)(B).[44] However, married taxpayers who file separately must each qualify on their own.[45]

Note. Once a taxpayer qualifies as a real estate professional, the spouse's participation can be taken into consideration to determine **material participation** in the rental real estate activity.[46] Under this "spousal attribution rule," the spouses do not need to file a joint return to meet material participation requirements.

Example 4. Hayden is a full-time salesman and his wife, Abbey, is a full-time office manager. In 2019, Hayden and Abbey own rental properties with losses they want to fully deduct. They maintained time logs showing the hours spent on their real estate rental activities.

Abbey seeks to qualify as a real estate professional under §469(c)(7). Hayden and Abbey file a joint return. First, Abbey must show she satisfies both the 750-hour test and the 50% test on her own for 2019. If she does, then the determination of whether she materially participated in the rental activities can be satisfied by taking into account Hayden's material participation, if any. Additionally, they can also file a grouping election to treat all of the rental activities as a single activity.

If Hayden and Abbey cannot satisfy the material participation test, they may be able to deduct up to $25,000 of losses under the exception for active participation contained in §469(i). To be eligible, they must meet the AGI requirement.[47]

Observation. As mentioned earlier, satisfaction of the 50% test and the 750-hour test of §469(c)(7) qualifies the taxpayer as a real estate professional. It does not, however, mean the rental activities are presumed to be nonpassive. To have the rental activities treated as nonpassive, the taxpayer must materially participate in each separate rental activity unless a grouping election is made under Treas. Reg. §1.469-9.

Once it is established the taxpayer qualifies as a real estate professional, material participation must be established. Each rental activity in which the taxpayer materially participates is treated as nonpassive. Rental activities in which the taxpayer does not materially participate are passive even though the taxpayer is a real estate professional.[48]

Note. A taxpayer who qualifies as a real estate professional but has passive real estate rental losses can use those losses to the extent the active participation exception of §469(i) allows.

44. Conf. Rept. No. 103-213, PL 103-66, p. 547. See also Treas. Reg. §1.469-9(c)(4) .

45. See, e.g., *Oderio v. Comm'r,* TC Memo 2014-39 (Mar. 10, 2014).

46. IRS Pub. 925, *Passive Activity and At-Risk Rules* (2018), p. 6.

47. For a case discussing the various aspects of IRC §469, see *Martin v. Comm'r,* TC Memo 2018-109 (Jul. 11, 2018).

48. See, e.g., *Gragg v. U.S.,* 831 F.3d 1189 (9th Cir. 2016).

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Real Property Trades or Businesses

To qualify for the real estate professional exception to the passive loss rules, the taxpayer must perform services in real property trades or businesses. Under §469(c)(7)(C), real property trades or businesses include the following.

- Real property development
- Redevelopment
- Construction
- Reconstruction
- Acquisition
- Conversion
- Rental
- Operation
- Management
- Leasing
- Brokerage

Mortgage Brokers and Real Estate Agents. In general, a mortgage broker is **not** deemed to be engaged in real property trades or businesses for purposes of the real estate professional exception to the passive loss rules even if state law considers the taxpayer to be in a real estate business. The courts and the IRS have determined that a brokerage, to be a real estate business, must involve the bringing together of real estate buyers and sellers. It does not include brokering financial instruments.[49] The definition of real property trades or businesses also does not include mortgage brokering.[50] However, if a licensed real estate agent negotiates real estate contracts, lists real estate for sale, and finds prospective buyers, those circumstances are likely sufficient for the agent to be deemed to be in real property trades or businesses for purposes of the passive loss rules.[51]

Licensed Appraiser. A licensed real estate appraiser may be determined to be in real property trades or businesses if the facts support the position.[52] A real estate appraisal business involves direct work in the real estate industry. However, associated services only indirectly related to real property trades or businesses (such as a service business associated with real estate) do not appear to meet the requirements of §469(c)(7).[53]

> **Note.** The IRS takes the position in its passive activities audit technique guide that services indirectly related to work in the real estate industry do not constitute real property trades or businesses. See the IRS *Passive Activity Loss Audit Technique Guide* at **uofi.tax/19b4x1** [www.irs.gov/pub/irs-mssp/pal.pdf].

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49. See, e.g., *Guarino v. Comm'r,* TC Summ. Op. 2016-12 (Mar. 14, 2016); CCA 201504010 (Dec. 17, 2014).
50. See, e.g., *Hickam v. Comm'r,* TC Summ. Op. 2017-66 (Aug. 17, 2017).
51. See, e.g., *Agarwal v. Comm'r,* TC Summ. Op. 2009-29 (Mar. 2, 2009).
52. See, e.g., *Calvanico v. Comm'r,* TC Summ. Op. 2015-64 (Nov. 9, 2015).
53. The IRS position is that a lawyer or accountant working with real estate clients is not directly engaged in the real estate business and, thus, is not engaged in a real property trade or business. See *Passive Activity Loss Audit Technique Guide.* IRS. [www.irs.gov/pub/irs-mssp/pal.pdf] Accessed on Jun. 17, 2019.

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Management Companies. A real estate management company is generally engaged in real property trades or businesses.[54] Services performed that directly relate to real property trades or businesses include putting together rental arrangements, managing leases, dealing with tenant housing, etc. However, economic-related activities such as legal and accounting services are only indirectly related to the real estate.[55]

> **Note.** A taxpayer must have at least 5% or more ownership in the management company for the taxpayer's hours to count toward the §469(c)(7) tests.[56] This bars most taxpayers employed by real estate management companies but who do not directly perform real estate work from qualifying for the real estate professional exception.

Multiple Activities and Grouping. Generally, a taxpayer who is a real estate professional must establish material participation in each rental activity separately.[57] However, the regulations provide that real property trades or businesses can be composed of multiple real estate trade or business activities.[58] This implies multiple real estate trades and businesses can be grouped together into a single activity. Treas. Reg. §1.469-4 allows the grouping of activities representing an "appropriate economic unit." Under that standard, nonrental activities cannot be grouped with rental activities unless they meet the appropriate economic unit test. However, two or more rental activities may be grouped with each other. Consequently, if necessary, a taxpayer not materially participating in individual rental activities may group two or more of the rental real estate activities to establish material participation for purposes of determining real estate professional status. The grouping of separate rental activities may allow the taxpayer to meet the more-than-750-hour test and the more-than-50% test.

Treas. Reg. §1.469-9(g) allows a real estate professional to group all interests in rental activities as a single activity.[59] When this election is made, the real estate professional must add all time spent on all rental activities together for purposes of testing material participation in the rental real estate activity.[60] The taxpayer makes the grouping election by filing a statement with their original tax return for the tax year. The statement should state the taxpayer is a qualified real estate professional for the tax year and is making the election under §469(c)(7)(A). The taxpayer cannot make the election by simply including all of their rental activities into one column on Schedule E, *Supplemental Income and Loss*.[61] The grouping election is binding for the tax year for which it is made. It is also binding for all future years the taxpayer is a qualifying real estate professional. **The failure to make the election in one year does not prohibit the taxpayer from making the election in a later year.**[62]

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54. See, e.g., *Stanley v. U.S.,* No. 5:14-CV-05236, 2015 U.S. Dist. LEXIS 153166 (W.D. Ark. Nov. 12, 2015), *nonacq.* AOD 2017-07 (Oct. 16, 2017).

55. Ibid. While the court in *Stanley v. U.S.* noted that the taxpayer's hours providing legal services counted toward the real estate professional tests, the taxpayer owned and worked for the real estate management company and also served as its general counsel. The court noted that IRC §469 does not require services performed in real property trades or businesses to be of any particular character or that all of the services be directly related to real estate. The services need only be performed in real property trades or businesses in which the taxpayer materially participates. However, the IRS issued a non-acquiescence to the court's decision.

56. IRC §469(c)(7)(D)(ii); Treas. Reg. §1.469-9(c)(5).

57. IRC §469(c)(7)(A)(ii).

58. IRC §469(c)(7)(A), flush language; Treas. Reg. §1.469-9(d)(1).

59. The election cannot be made unless the taxpayer is a qualifying real estate professional and has no effect in years that the taxpayer is not a qualifying real estate professional. Treas. Reg. §1.469-9(g)(1). In addition, the election is an "all-or-nothing" election. If the election is made, all of the taxpayer's rental activities are grouped for purposes of testing for material participation. In addition, any new rental activity that the taxpayer acquires in a year after the grouping election is in place will be subject to the grouping election.

60. Any nonrental activity is not included in the grouping. Only the hours spent in the rental activities can count toward material participation for purposes of grouping. See, e.g., *Bailey v. Comm'r,* TC Memo 2001-296 (Nov. 7, 2001).

61. See, e.g., *Kosonen v. Comm'r,* TC Memo 2000-107 (Mar. 28, 2000).

62. If a timely election is not made, a late election can be made if tax returns have been filed that are consistent with having made the election for all tax years for which the taxpayer is seeking late relief. The procedures set forth in Rev. Proc. 2011-34, 2011-24 IRB 875 must be followed to make a late election. The ability to make a late election can be very important. See, e.g., *Estate of Ramirez v. Comm'r,* TC Memo 2018-196 (Nov. 28, 2018).

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Note. Regroupings are not allowed in later years unless the facts and circumstances change significantly or the initial grouping was clearly inappropriate.[63] To revoke the election for such a year, a statement must be filed with the taxpayer's original tax return for the year of revocation. The statement must contain a declaration that the taxpayer is revoking the election under §469(c)(7)(A) and an explanation of the nature of the change in the facts and circumstances.[64]

Note. For more information on grouping of passive activities, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

On occasion, when a taxpayer makes an election to group all real estate rental activities, the taxpayer does not hold all of the interests in real estate activities individually. The regulations address this possibility and use an example of an interest in a rental real estate activity held by the taxpayer as a limited partnership interest.[65] The effect of the grouping election does not necessarily apply in this situation. Instead, the taxpayer's combined rental activities are deemed to be a limited partnership interest when determining material participation. In addition, the taxpayer must establish material participation under one of the tests that determine the material participation of a limited partner contained in Temp. Treas. Reg. §1.469-5T(e)(2).[66]

A de minimis exception applies when the taxpayer's share of gross rental income from all limited partnership interests in rental real estate is less than 10% of the taxpayer's share of gross rental income from all of the taxpayer's interests in rental real estate for the tax year. In this situation, the taxpayer can determine material participation by using any of the seven tests for material participation in Temp. Treas. Reg. §1.469-5T(a) that apply to rental real estate activities.[67] This de minimis exception also applies when the taxpayer has an interest in a rental real estate activity via an LLC. An LLC interest is not treated as a limited partnership interest for this purpose.[68]

Observation. In its 2017–2018 Priority Guidance Plan,[69] the IRS stated it planned to finalize regulations under §469(h)(2). The provision creates a per se rule of non-material participation for limited partner interests in a limited partnership unless the Treasury specifies differently in regulations. Those regulations were initially issued in temporary form and became proposed regulations in 2011. Until the IRS takes action to effectively overturn the Tax Court decisions via regulation, the issue will depend on an analysis of a particular state's LLC statute and whether there are sufficient factors under the state statute that distinguish an LLC from a limited partnership.

Note. Once the taxpayer makes a grouping election, their combined rental real estate activity is treated as a single activity for §469 purposes. Passive losses (including suspended losses) attributable to a grouped activity the taxpayer disposes of are not available until the taxpayer disposes of substantially all of the grouped rental activity.

63. Treas. Reg. §1.469-9(d)(2).

64. Treas. Reg. §1.469-9(g)(3).

65. Treas. Reg. §1.469-9(f)(1).

66. Treas. Reg. §1.469-9(f)(1). Those tests are the 500-hour test, the personal service activity test, and the facts and circumstances test.

67. Treas. Reg. §1.469-9(f)(2).

68. See, e.g., *Garnett v. Comm'r,* 132 TC 368 (2009); *Hegarty v. Comm'r,* TC Summ. Op. 2009-153 (Oct. 6, 2009); *Newell v. Comm'r,* TC Memo 2010-23 (Feb. 16, 2010); *Thompson v. Comm'r,* 87 Fed. Cl. 728 (2009), *acq. in result only,* AOD 2010-002 (Apr. 5, 2010); *Chambers v. Comm'r,* TC Summ. Op. 2012-91 (Sep. 12, 2012).

69. *2017–2018 Priority Guidance Plan.* IRS. [www.irs.gov/pub/irs-utl/2017-2018_pgp_initial.pdf] Accessed on Jun. 25, 2019.

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In Chief Counsel Advice 201427016,[70] the IRS stated the Treas. Reg. §1.469-9(g) grouping election "is relevant only **after** the determination of whether the taxpayer is a qualifying taxpayer." The election under Treas. Reg. §1.469-9(g) has no bearing on the issue of whether a taxpayer qualifies as a real estate professional (participates more than 750 hours in real estate activities and satisfies the 50% test).[71] However, grouping can make it easier for the taxpayer to meet the required hours test of §469(c)(7) and be deemed as materially participating in the activity.

To reiterate, as a real estate professional, the taxpayer could elect to group all rental activities for purposes of satisfying the material participation test in the grouped activity. If the taxpayer satisfies the test, then the grouped activities are nonpassive. The converse is also true. If the taxpayer does not satisfy the material participation test, then all the grouped activities are passive.

Trusts

The IRS takes the position that only an **individual** can be a real estate professional for purposes of the passive loss rules.[72] This is an important distinction because many trusts hold rental property. According to the IRS's position, the only way trust rental income can be nonpassive is if the trustee, acting in their capacity as trustee, satisfies the tests of §469(c)(7). One federal district court that addressed the issue rejected the IRS position.[73] However, the Tax Court has held otherwise.

In *Frank Aragona Trust v. Comm'r,*[74] a trust incurred losses from rental activities the IRS treated as passive. The trust had six trustees—the settlor's five children and an independent trustee. One of the children handled the daily operation of the trust activities and the other trustees acted as a managing board. In addition, three of the children (including the one handling daily operations) were full-time employees of an LLC the trust owned. The LLC was treated as a disregarded entity and operated most of the rental properties. The trust had essentially no activity other than the rental real estate. The IRS, in treating the losses as passive, said the trustees were acting as LLC employees and not as trustees. The Tax Court disagreed with the IRS's position, finding the trust materially participated in the rental real estate activities and the losses were nonpassive. The trustees, the Tax Court noted, managed the trust assets for the beneficiaries, and if the trustees are individuals and work in a trade or business as part of their duties, then their work is "performed by an individual in connection with a trade or business." **Thus, a trust, rather than just the trustees, is capable of performing personal services.**

> **Observation.** The Tax Court's position in *Frank Aragona Trust* is particularly important for many rental activities. A great deal of leased real estate is held in trust. The trust may be able to meet the material participation standard via the trustees' conduct. This would allow losses to be fully deducted. In addition, the trust income is not subjected to the 3.8% NIIT under IRC §1411.

70. CCA 201427016 (Apr. 28, 2014). In the CCA, the IRS conceded in *Jafarpour v. Comm'r,* TC Memo 2012-165 (Jun. 12, 2012), that the election applies only after a taxpayer has qualified as a real estate professional and only for the purpose of determining material participation in the real estate professional's rental activities.

71. See also *Miller v. Comm'r,* TC Memo 2011-219 (Sep. 8, 2011).

72. CCA 201244017 (Nov. 2, 2012).

73. *Mattie K. Carter Trust v. U.S.,* 256 F.Supp.2d 536 (N.D. Tex. 2003).

74. *Frank Aragona Trust v. Comm'r,* 142 TC 165 (2014).

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SELF-RENTALS[75]

Taxpayers sometimes use multiple entities for their business structure. Multiple entities may be established for estate and business planning as well as tax planning or liability purposes. Examples of this "multi-entity" approach may involve individual ownership by a taxpayer of real property that is rented to a separate operating entity owned by the same taxpayer.

Often, such a "self-rental" situation causes the activities to be recharacterized for passive loss purposes. The net rental income from an item of property can be recharacterized as **nonpassive** if the income is derived from rent for use in a business activity in which the taxpayer materially participates.[76] **Recharacterization only applies if there is net income from the self-rental activity. Any losses remain passive.** The losses cannot be recognized until the complete disposition of the activity.[77]

While an exception exists for rentals in accordance with a written binding contract entered into before February 19, 1988, the lease must have been a long-term lease at the time it was entered into for the grandfathering provision to apply.[78] It is not possible to renew or draft an addendum to the original lease and qualify for the exception.[79] This rule applies to noncorporate entities as well as pass-through entities such as S corporations.[80]

> **Example 5.** For estate and business planning purposes, Jenny placed the operations of her retail store in an S corporation, of which she is the sole shareholder and employee. Jenny continued to own her building individually and rented it to her S corporation.
>
> Jenny reported the rental income on her Schedule E. Because the rental income is derived from a business in which Jenny materially participates, she cannot report the rental income on Form 8582. The net rental income is treated as coming from a nonpassive activity. Jenny cannot use any other potential passive losses that she may have to offset the nonpassive rental income from her building.

A taxpayer can make an election to group multiple rentals to treat them as a single activity for passive loss purposes if the rental activities represent an appropriate economic unit.[81] However, such a grouping election does not negate the self-rental rule.[82]

> **Note.** In *Carlos v. Comm'r,*[83] taxpayers were unable to combine a self-rental income property with any other passive loss property. It did not matter whether the other property incurred a self-rental loss; the court held that the profit or loss from the self-rental property was not available to be used against the other property. Clients in a similar position should be alerted to the risk.

75. Treas. Regs. §§1.199A-1(b)(14) and 1.199A-4(b)(1)(i).

76. Treas. Reg. §1.469-2(f)(6).

77. IRC §469(g).

78. Treas. Reg. §1.469-11(c)(1)(ii) .

79. See, e.g., *Krukowski v. Comm'r,* 114 TC 366 (2000), *aff'g* 239 F.3d 547 (7th Cir. 2002).

80. *Williams v. Comm'r,* No. 15-60341, 2016 U.S. App. LEXIS 1756 (5th Cir. 2016), *aff'g* TC Memo 2015-76.

81. Treas. Reg. §1.469-4(c) .

82. See, e.g., *Carlos v. Comm'r,* 123 TC 275 (2000).

83. *Carlos v. Comm'r,* 123 TC 275 (2000).

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Separating self-rental property with income from other passive properties is only detrimental if the other passive properties produce a loss. If no prior grouping election was made, consideration should be given to grouping property with a self-rental loss associated with a business activity if there is identical ownership and if the taxpayer participates in the business activity.[84] In addition, a rental activity can be grouped with a business activity if the rental activity is insubstantial in relation to the business activity. By grouping the rental and the business together, the rental activity loss is no longer treated as passive if the owner materially participates in the business.[85]

Example 6. Bill and Belinda are married and file joint returns. They own two commercial properties leased to a business entity (an S corporation) they own and operate in a neighboring community. One of the buildings generates cash rental income of $200,000. The other building produces an $80,000 loss.

On their Schedule E for the tax year, they elect to group the two buildings together as a single activity. As a result, they report net rental income of $120,000. However, under the self-rental regulation, the $200,000 of income from one building is recharacterized as nonpassive and the $80,000 loss remains passive and cannot offset the $200,000 of income. The $80,000 loss is suspended as a passive activity loss and reported on Form 8582.

Practitioner Planning Tip

Bill and Belinda may want to consider **grouping** the rental activity producing a loss with their operating entity. They can do this **if** the activities together constitute an **appropriate economic unit** and the rental activity is **insubstantial** in relation to the business activity (or the business activity is insubstantial in relation to the rental activity).[86]

Note. To define "insubstantial," the Treasury originally created an "80/20 test" for purposes of grouping rental and nonrental activities.[87] Under that test, rental and nonrental activities may be grouped "if more than 80% of the income of the [activity]… is attributable to one class of operations (i.e., rental or nonrental)." While this temporary regulation is no longer in place and the final regulations do not adopt a bright-line or safe harbor gross revenue test, the courts still view the 80/20 test as an appropriate representation of what constitutes "insubstantial."[88]

Self-Rental Rule and the Net Investment Income Tax

The 3.8% NIIT applies to taxpayers with passive income exceeding $250,000 on a joint return ($125,000 for married taxpayers filing separately and $200,000 for other filing statuses).[89] Generally, the passive loss rules apply in determining whether an IRC §162 trade or business is passive for NIIT purposes. Thus, if a taxpayer has rental income from an activity in which the taxpayer materially participates, the NIIT does not apply.

84. See Treas. Reg. §1.469-4(d)(1)(ii).

85. A taxpayer that qualifies as a real estate professional can group a rental activity with any other activity for purposes of the passive loss rules under Treas. Reg. §1.469-4(d)(1). See *Stanley v. U.S.,* No. 5:14-cv-05236, 2015 U.S. Dist. LEXIS 153166 (W.D. Ark. Nov. 12, 2015), *nonacq.* AOD 2017-07 (Oct. 16, 2017).

86. Treas. Reg. §1.469-4(d)(1)(ii).

87. Temp. Treas. Reg. §1.469-4T.

88. See, e.g., *Candelaria v. U.S.,* 518 F. Supp. 2d 852 (W.D. Tex. 2007).

89. IRC §§1411(a)(1) and (b).

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This raises the question: what about the self-rental recharacterization rule? Treas. Reg. §1.1411-5(b)(2) states the following.

> *To the extent that any income or gain from a trade or business is recharacterized as 'not from a passive activity' by reason of… §1.469-2(f)(6), such trade or business does not constitute a passive activity… with respect to such recharacterized income or gain.*

If the self-rental recharacterization rule applies, it causes the trade or business at issue to **not** be treated as a passive activity for NIIT purposes but only with respect to the recharacterized income or gain.[90] When gross rental income is treated as not being derived from a passive activity because of grouping a rental activity with a trade or business activity, the gross rental income is deemed to be derived in the ordinary course of a trade or business.[91] Consequently, the NIIT does not apply.[92]

For purposes of the NIIT, the self-rental rule is applied on a person-by-person basis. There can be situations involving multiple owners in a rental entity, with some who are subject to the NIIT and others who are not subject to the NIIT based on individual levels of participation in the activity.

A spousal attribution rule can apply. Under this rule, if property owned by the taxpayers is rented to the materially participating **spouse's** business, it is **not** subject to the NIIT. Because spouses are considered one taxpayer for purposes of the regular passive loss rules, the rental income is not passive in the hands of the spouse who is not materially participating in the business activity.[93]

Tax Court's Decision for S Corporations

Even though the passive loss rules of §469 do not specify that they apply to S corporations, the Tax Court has held the self-rental rule applies to rentals by S corporations. In *Williams v. Comm'r,*[94] the taxpayers (a married couple) owned 100% of an S corporation and 100% of a C corporation. The husband worked full-time for the C corporation during 2009 and 2010 and materially participated in its activities. Neither of the taxpayers materially participated in the S corporation or the rental of commercial real estate to the C corporation. They also were not engaged in real property trades or businesses. In 2009 and 2010, the S corporation leased commercial real estate to the C corporation so that the C corporation could use the property in its business. For those years, the S corporation had net rental income the taxpayers reported as passive income on Schedule E, which they then offset with passive losses. The IRS disagreed and recharacterized the rental income as nonpassive under the self-rental rule.

In upholding the IRS's position, the Tax Court determined that pass-through entities are subject to §469 (which included the taxpayers' S corporation) even though they are not specifically mentioned by the statute. They did not need to be mentioned, the Tax Court reasoned, because they were not taxpayers. The Tax Court also rejected the taxpayers' argument that the self-rental rule did not apply because the S corporation did not participate in the C corporation's trade or business. The husband's material participation in the C corporation's business was sufficient to trigger the application of the self-rental rule. The rental income from the lease was nonpassive.

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90. Treas. Reg. §1.1411-5(b)(2)(iii).

91. Thus, any resulting gain from the sale of assets would also be nonpassive.

92. Treas. Reg. §1.1411-4(g)(6)(i).

93. IRC §469(h)(5); *Connor v. Comm'r,* TC Memo 1999-185, *aff'd,* 218 F.3d 733 (7th Cir. 2000).

94. *Williams v. Comm'r,* TC Memo 2015-76 (Apr. 16, 2015).

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QBID AND THE PROPOSED RENTAL REAL ESTATE SAFE HARBOR[95]

After the Treasury issued proposed §199A regulations, many tax professionals commented on the lack of guidance in determining what activities **rise to the level of a §162 trade or business** for purposes of the qualified business income deduction (QBID) and specifically how that requirement is applied to real estate activities.[96] The Treasury responded to these comments from the tax practitioner community by issuing a proposed trade or business safe harbor for rental real estate enterprises.[97]

The Treasury indicated the purpose of the **proposed** real estate safe harbor is to clarify the circumstances in which a rental real estate enterprise (RREE) **will be treated** as a trade or business **only** for purposes of the QBID. However, this should **not** be interpreted as meaning that RREEs that fail the safe harbor do not qualify for the QBID. They may nevertheless qualify if they otherwise meet the §162 trade or business standard.

This safe harbor applies to taxpayers (including relevant pass-through entities (RPEs)) with tax years ending **after** December 31, 2017.

RENTAL REAL ESTATE ENTERPRISE

For the purpose of the safe harbor, an RREE is defined as an interest in real property held for the production of rents. It may consist of an interest in multiple properties.

Taxpayers can hold an interest in an RREE either directly or through an RPE and must treat each RREE as a separate enterprise or combine similar RREEs as a **single** enterprise. Commercial and residential real estate may **not** be part of the same RREE, and taxpayers cannot vary this tax treatment from year-to-year absent a significant change in facts and circumstances.

SAFE HARBOR REQUIREMENTS

Each tax year, the following requirements must be met for the §199A safe harbor to apply to an RREE.

1. Separate books recording income and deductions of the RREE are maintained.
2. At least 250 hours of **rental services** are performed in the tax year with respect to the RREE (for tax years **ending** after December 31, 2017, and **beginning** prior to January 1, 2023). For tax years beginning after December 31, 2022, at least 250 hours of rental services are performed in any three of the five consecutive tax years that end with the tax year (or in each year for an RREE held less than five years).
3. The taxpayer maintains contemporaneous records regarding **all** services performed for the RREE. These records include time reports, logs, or similar documents regarding the following.
    a. Hours of **all** services performed
    b. Description of **all** services performed
    c. Dates on which such services were performed
    d. Who performed the services

    These records must be available for inspection at the request of the IRS. The contemporaneous records requirement does **not** apply to tax years beginning **before** January 1, 2019.

95. IRS Notice 2019-07, 2019-09 IRB 740.
96. TD 9847, 2019-09 IRB 670, 673.
97. IRS Notice 2019-07, 2019-09 IRB 740.

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Rental Services

The safe harbor defines rental services as including the following.

- Advertising to rent or lease the real estate
- Negotiating and executing leases
- Verifying information contained in prospective tenant applications
- Collection of rent
- Daily operation, maintenance, and repair of the property
- Management of the real estate
- Purchase of materials
- Supervision of employees and independent contractors

Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners.

Excluded Services. The following activities are **not** considered rental services.

- Financial or investment management activities, such as arranging financing
- Procuring property
- Studying and reviewing financial statements or reports on operations
- Planning, managing, or constructing long-term capital improvements
- Time spent traveling to and from the real estate

Practitioner Planning Tip

It is recommended that practitioners advise their clients to clearly identify both included and excluded services in their contemporaneous records of rental services.

Safe Harbor Exclusions

Personal Residence. Real estate **used** by the **taxpayer** (including the owner or the beneficiary of an RPE owning the property) as a residence for any part of the year is **excluded** from the safe harbor. For this purpose, taxpayer **use** is defined under IRC §280A(d). Thus, real estate is excluded from the safe harbor if, during the tax year, the taxpayer uses the property (or a portion thereof) for personal purposes for a number of days exceeding the greater of:

1. 14 days, or
2. 10% of the number of days during the year that the property is rented at a fair rental.

Triple Net Lease. Real estate rented or leased under a triple net lease is also **excluded** from the safe harbor. For this purpose, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance and to be responsible for maintenance activities for the property in addition to rent and utilities.

This also includes a lease agreement that requires the tenant/lessee to pay a portion of the taxes, fees, and insurance and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

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Claiming the Safe Harbor

In order to use the safe harbor, the taxpayer or RPE must attach a statement to their tax return attesting that they satisfied the requirements of §3.03 of the revenue procedure contained in IRS Notice 2019-07.

The statement must include the following declaration **signed** by the taxpayer(s).

> *Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete.*

If the taxpayer is an RPE, then the statement must be signed by its authorized representative. The signer of the statement must possess personal knowledge of the facts and circumstances related to the statement.

> **Note.** For complete discussions of QBID and Tax Cuts and Jobs Act (TCJA) issues, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update, and Chapter 2: New Developments.

SELF-RENTAL RULE AND NON-SSTBs

The rental or licensing of tangible or intangible property to a related trade or business (i.e., a self-rental) may be **treated as** a trade or business if the rental or licensing activity and the other trade or business are commonly controlled under the provisions of Treas. Reg. §1.199A-4(b)(1)(i).

The regulations provide two clarifications concerning this exception.

1. The related party must be an individual or an RPE.
2. The term **related party** is defined under the IRC §§267(b) or 707(b) attribution rules.

Under §267(b), related parties include C corporations. However, the preamble to the final regulations reiterates that the self-rental exception to the §162 trade or business standard only applies in situations in which the related party is an individual or RPE.

Triple net lease arrangements are ineligible for the RREE safe harbor. Nevertheless, based on the preamble to the final §199A regulations, **triple net leases that are self-rentals** should be able to take advantage of the self-rental exception.

Example 7. Mary White runs a retail business that has a net profit of $100,000, which she reports on her 2019 Schedule C, *Profit or Loss From Business.* The building hosting the retail business is owned by MW Properties, an S corporation wholly owned by Mary. MW Properties' only activity is the rental of the building to Mary's retail business under a triple net lease arrangement. The ordinary business income reported on the corporation's 2019 Form 1120S, *U.S. Income Tax Return for an S Corporation,* is $20,000.

Because MW Properties is an RPE related to Mary that she controls, MW Properties is **treated as a business** for purposes of the QBID. Therefore, Mary's QBI is $120,000 ($100,000 from the retail business plus $20,000 from the S corporation).

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SELF RENTALS AND SSTBs

> **Observation.** It is important to remember that the safe-harbor is just that-a safe-harbor. A rental activity can qualify as an IRC §162 trade or business without meeting the safe harbor requirements if the facts and circumstances support such a finding.

Under the final §199A regulations, a self-rental constitutes a §162 trade or business for QBID purposes if the rental involves commonly controlled entities (either directly or via attribution under §§267(b) or 707(b)) when the self-rental income is not received from a C corporation.[98] The final regulations also bar taxpayers from shifting SSTB income to non-SSTB status by using a self-rental activity when property or services are provided to an SSTB by a trade or business with common ownership.[99] Under these rules, a portion of the trade or business that provides property to the commonly owned SSTB is treated as part of the SSTB with respect to the related parties if there is at least 50% common ownership.[100]

Example 8. A group of CPAs own a building. They lease 80% of the building space to the CPA firm and 20% of the building to an unrelated chiropractor. The income from the chiropractor is classified as non-SSTB income while the income from the CPA firm is treated as SSTB income.

Aggregation under §199A of a self-rental activity with the taxpayer's operating entity, if they are part of a common group and have the same tax year, causes the rent to be aggregated with the business income.[101] This can optimize the use of the 20% QBID (with the possible exception of rental to an SSTB as noted above.)

LEASE OF LAND[102]

Prop. Treas. Reg. §1.199A-1(d)(4) provided that, for purposes of the examples included with the regulation, all the businesses described therein were **assumed** to be trades or business for purposes of the QBID.[103] Consequently, some commenters questioned whether the first two examples in the proposed regulations were intended to imply that the lease of unimproved land is a trade or business for purposes of §199A.

In the first example, a taxpayer owned parcels of land that he leased to airports to use as parking lots. The business paid no wages and did not hold any qualified property because the land was not depreciable. The taxpayer's total taxable income was over the income threshold for the QBID. As a result, he was not eligible for the QBID because the business paid no wages and held no qualified property.

In the second example, the facts were the same except the business expended money to build depreciable parking structures on the parcels. The taxpayer leased the parking structures and the land to the airports. In this example, the taxpayer was eligible for the QBID because, although the taxpayer's income was over the threshold, the business had qualified property. Accordingly, the taxpayer's QBID was limited to 2.5% of the unadjusted basis immediately after acquisition (UBIA) of the qualified property.

The first example illustrated how the QBID calculation would work if a taxpayer did not have W-2 wages or qualified property. The second example added qualified property to the fact pattern. The final regulations clarified that these examples were not intended to imply that the lease of the land is, or is not, a trade or business for purposes of §199A. To avoid confusion, the final regulations removed the references to land in both examples.

Consequently, the rental of unimproved land like any other RREE must meet either the general §162 trade or business standard, the safe harbor, or be a qualifying self-rental to be treated as a qualified activity for purposes of §199A.

98. Treas. Reg. §1.199A-4(b)(1)(i) and TD 9847, 2019-09 IRB 670, 674.

99. Treas. Reg. §1.199A-5(c)(2).

100. Ibid.

101. Treas. Reg. §1.199A-4.

102. Treas. Regs. §§1.199A-1(b)(14) and 1.199A-4(b)(1)(i).

103. See IRC §199A.

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COST SEGREGATION

OVERVIEW

A real property asset (e.g., land with improvements or a building) often is made up of various classes of components, some of which are items of personal property and others are components within the same asset class (i.e., roof, HVAC, electrical systems, etc.). Cost segregation is the practice of taking such assets and splitting associated structural component parts into a group or groups of smaller assets that can be depreciated over shorter lives.[104] A cost segregation study can also be performed to separate classes of assets so that, in the event of replacement (a roof for example), undepreciated basis can be recovered.

Firms performing cost segregation studies commonly utilize professionals with valuation skills and knowledge of construction methods, materials, costs, and the applicable income tax rules.

> **Note.** According to the American Society of Cost Segregation Professionals, cost segregation is "the process of identifying property components that are considered 'personal property' or 'land improvements' under the federal tax code."[105] Cost segregation is the engineering and accounting process of identifying those items of personal property that are contained within real property and separating out the items of personal property for modified accelerated cost recovery system (MACRS) purposes. Land is not depreciable, but structures associated with land are. This means there may be opportunities to allocate costs to personal property or land improvements that are depreciable.

GENERAL COST SEGREGATION STUDY PROCEDURE[106]

A cost segregation study generally begins with a site inspection leading to a determination of the total income tax basis for the property at issue—particularly the land value. Once land value is determined, the study determines the value of personal property, taking into account wear and tear. Items of personal property with assigned values are listed and land improvements and the value assigned to them are listed separately. Some land improvements are worth more than their original cost; for example, full-grown trees are worth more than their original cost. Other land improvements are worth less than the original cost due to deterioration. For the valuation of a building, once the personal property and land improvements are segregated and valued, the remaining depreciable value is assigned to the building. All values are assigned using acceptable cost estimates, and appropriate unit factor prices and/or multipliers should be used to adjust the values in accordance with location, deflation, and depreciation.

Worksheets are then prepared, with each asset separated into the appropriate asset class and a value assigned to it. The asset classes and associated depreciable lives for personal property and land improvements should be in accordance with Rev. Proc. 87-56.[107]

Purpose and Goal of a Cost Segregation Study

As noted earlier, a cost segregation study is the process used to identify and reclassify as tangible personal property structural components that have shorter MACRS recovery periods than the structures in which they are contained. This is done to achieve accelerated depreciation deductions or to separate out various components in the same asset class.

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104. See Treas. Reg. §1.48-1(e)(2) (provides guidance on the definition of a "structural component").

105. *What is Cost Segregation?* American Society of Cost Segregation Professionals. [https://ascsp.org] Accessed on Jul. 10, 2019.

106. *Cost Segregation Audit Techniques Guide.* IRS. [www.irs.gov/businesses/cost-segregation-audit-techniques-guide-chapter-3-cost-segregation-approaches] Accessed on Jul. 9, 2019.

107. Rev. Proc. 87-56, 1987-2 CB 674.

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The purpose of classifying and separating assets into those with shorter class lives (e.g., 5, 7, 10, or 15 years) than a building (e.g., 20, 27.5, or 39-year MACRS property) is to reduce the taxpayer's current tax liability and increase cash flow. After a cost segregation study, the structural components of a building are often depreciable over five to seven years. This includes such items as moveable walls, carpet, tile, cabinetry, etc.

The goal of a cost segregation study is to find assets that are affixed to the building but are not involved with the building's overall operation and maintenance, as well as those assets that are outside of the building structure and affixed to land that also do not relate to the building's operation and maintenance (such as land improvements).

Note. Land improvements (which are 15-year MACRS property) include parking lots, driveways, paved areas, site utilities, walkways, sidewalks, curbing, concrete stairs, fencing, retaining walls, block walls, carports, dumpster enclosures, and landscaping. Landscaping can be broken down into plants, trees, shrubs, sod, mulch, rock, and security lighting.[108]

Allocation Between IRC §§1245 and 1250 Property

Distinguishing between IRC §§1245 and 1250 property via a cost segregation study is important because first-year bonus depreciation is presently set at 100% of a qualified asset's cost basis through 2022.[109] To be qualified property, the MACRS rules must apply with a recovery period of 20 years or less. This means §1250 property that is a nonresidential building (and the building's structural components) does not qualify for bonus depreciation because the building is 39-year recovery property under MACRS.[110] By contrast, most types of §1245 property are tangible personal property eligible for bonus depreciation under IRC §168(k), as well as expensing under IRC §179.[111]

In determining whether an item is a structural component, the courts[112] tend to look at the ultimate use of an item. If an item's ultimate use is for the operation and maintenance of a building, it is not tangible personal property. If, however, an item's ultimate use is directly applicable to the operation of an item of tangible personal property, then the item is treated as tangible personal property. This is, in effect, a use by the courts of the "sole justification" exception contained in the definition of structural components in Treas. Reg. §1.48-1(e)(2). Although the sole justification exception as described in the regulations appears to apply only to machinery required to meet temperature or humidity requirements essential for the operation of other machinery or the processing of materials, the courts have held there is no such limitation. The sole justification exception therefore applies to any items found in a building.[113]

Under the sole justification exception, if the sole reason for the existence of an item is the fact it serves or relates to an item of tangible personal property, the item will also be treated as tangible personal property, even if it incidentally or insubstantially serves operational and maintenance needs of a building.

108. *Cost Segregation Audit Techniques Guide.* IRS. 2016. [www.irs.gov/businesses/cost-segregation-audit-techniques-guide-table-of-contents] Accessed on Jun. 25, 2019.

109. IRC §168(k)(1)(A) and (6)(A), as amended by the TCJA.

110. Some types of land improvements, while having a 15-year recovery period, are eligible for bonus depreciation even though they are IRC §1250 property.

111. There is no statutory definition of "personal property" for depreciation purposes. The regulations state that the term is to be defined in the same manner that "tangible personal property" is defined under Treas. Reg. §1.48-1(c) (concerning property eligible for the (presently repealed) investment tax credit). Treas. Reg. §1.1245-2(b)(1).

112. *Hospital Corp. of America & Subs. v. Comm'r*, 109 TC 21 (1997).

113. *Boddie-Noelle Enterprises. Inc. v. U.S.*, 36 Fed.Cl. 722 (1996), *aff'd* without published opinion, 132 F.3d 54 (Fed.Cir. 1997).

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Example 9. Air conditioning is required to keep the temperature of a computer room low to help prevent overheating of computer components. The fact that the air conditioning also incidentally cools employee workspace does not prevent the air conditioner from being treated as tangible personal property. The sole justification for the air conditioner is to cool the computer equipment, which is tangible personal property.

It appears the Tax Court's interpretation of the sole justification exception[114] is that an entire item is treated as tangible personal property if there is only insubstantial support of operations and maintenance. Conversely, if there is only an insubstantial relationship between the item and an item of tangible personal property, no portion of the item is treated as tangible personal property. If, however, an item **both** contributes to the operation and maintenance of a building and to the support of an item of tangible personal property and neither use is insubstantial in relation to the other, the Tax Court permits an allocation of costs for purposes of the IRC §38 general business credit.

In *Hospital Corporation of America & Subsidiaries v. Comm'r,*[115] the Tax Court held the classification of property as real property or tangible personal property (i.e., distinguishing §1245 from §1250 property) for purposes of MACRS is determined on the basis of what the property's classification would have been for purposes of the (now repealed IRC §48) investment tax credit (ITC).[116] Under the ITC rules, if a component of a building satisfied certain requirements, it would be classified as tangible personal property rather than as part of the permanent building or its structural components, thereby entitling its basis to be recovered as tangible personal property through accelerated MACRS depreciation rather than as straight-line real property depreciation.[117] However, some courts have held that even if an item of property is listed in Treas. Reg. §1.48-1(e)(2) as being a structural component, it is not a structural component of a building to the extent the item does not relate to the operation or maintenance of the building.[118] In addition, the IRS has determined the ITC classification of property is not controlling for purposes of interest capitalization under IRC §263A(f).[119]

Observation. Together, the cases and the regulations seem to indicate that if component elements that are classified as tangible personal property as a result of a cost segregation study otherwise constitute buildings or structural components thereof, reclassified components will still be treated as real property for purposes of the like-kind exchange rules of IRC §1031.[120]

If property is inherently permanent (i.e., it cannot be separated from the structure without damaging the property), it is generally not treated as tangible personal property. While perhaps the most important factor, movability (by itself) is not the controlling factor in deciding whether property lacks permanence. The fact, however, that an item is not readily reusable in another location is evidence supporting the conclusion that it is to be treated as permanent in its present location.[121]

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114. *Amerisouth XXXII, Ltd. et al. v. Comm'r,* TC Memo 2012-67 (Mar. 12, 2012).

115. *Hospital Corporation of America & Subsidiaries v. Comm'r,* 109 TC 21 (1997), *acq.* and *non-acq.* 1999-35 IRB 314, as corrected by Ann. 99-116, 1999-52 IRB 763.

116. Property that was eligible for the ITC was referred to generally as "section 38 property."

117. However, some courts have held that even if an item of property is listed in Treas. Reg. §1.48-1(e)(2) as being a structural component, it is not a structural component of a building to the extent that the item does not relate to the operation or maintenance of the building. See, e.g., *Scott Paper Co. v. Comm'r,* 74 TC 137 (1980). In addition, property may be considered to be tangible personal property for ITC purposes even though it is classified as real property under state law. See Treas. Reg. §1.48-1(c).

118. See, e.g., *Scott Paper Co. v. Comm'r,* 74 TC 137 (1980). In other words, the ultimate use of the item is key to the distinction.

119. CCA 200648026 (Aug. 25, 2006).

120. *Cost Segregation Applied.* Soled, Jay A. and Falk, Charles E. Aug. 1, 2004. Journal of Accountancy. [www.journalofaccountancy.com/issues/2004/aug/costsegregationapplied.html] Accessed on Jul. 2, 2019.

121. CCA 200648026 (Aug. 25, 2006).

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The Tax Court has set forth six factors for analyzing whether property is inherently permanent.[122]

1. Whether the property is capable of being moved, and has in fact been moved
2. Whether the property is designed or constructed to remain permanently in place
3. Whether there are circumstances that tend to show the expected or intended length of affixation (i.e., whether there are circumstances that show the property may or will have to be moved)
4. The effort and time commitment needed to remove the property
5. The extent of damage the property can be expected to sustain upon removal
6. The manner in which the property is affixed to the land

Accounting Method. When the MACRS class life of an asset is changed, the taxpayer must obtain IRS consent to a change in accounting method. However, reclassifying an asset from §1250 real property to §1245 tangible personal property is within the automatic consent provisions of Rev. Proc. 2018-40.[123] Under this guidance, a taxpayer can change its method of accounting to claim depreciation deductions on assets that were previously underdepreciated. The additional depreciation is treated as a negative IRC §481(a) deduction and is deducted in the year of change. Because the change is subject to the automatic consent rules, no ruling request or user fees are required.

A "look-back" cost segregation study may also be used to identify missed deductions from prior years. Form 3115, *Application for Change in Accounting Method,* must be filed with the IRS to claim these "catch-up" deductions on the current year return. This can also be beneficial in certain circumstances in dealing with the limitations on deducting net operating losses under the post-2017 rules.

Note. For more information about changing an accounting method, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

Purchase Price Allocation Rules and Cost Segregation

When business assets are sold, the parties often negotiate and allocate the purchase price among the various assets. Generally, the buyer wants a significant portion of the purchase price allocated to depreciable assets in order to claim depreciation deductions over a shorter period (usually three to seven years depending upon asset type). The seller, on the other hand, may want the purchase price allocated primarily to intangible assets such as company goodwill, which may result in a lower tax obligation. Because of these competing interests, the IRS tends to respect the negotiated purchase price allocations of the parties if they follow the special asset allocation rules set forth in IRC §1060. IRC §1060 prescribes special allocation rules for determining a transferee's basis and a transferor's gain or loss in an asset acquisition.[124] Under §1060(c), an applicable asset acquisition is any transfer of assets that constitutes a trade or business when the purchaser's basis in the assets is determined wholly by reference to the consideration paid for them.

For an applicable asset acquisition, both the seller and the buyer must allocate the consideration paid among the assets transferred. The method of allocation is substantially the same as the residual allocation method required under IRC §338[125] when an election is made to treat the liquidation of a subsidiary corporation as a taxable acquisition of its assets and which is applicable for that purpose under the §1060 regulations.

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122. *Whiteco Industries, Inc. v. Comm'r,* 65 TC 664 (1975).

123. Rev. Proc. 2018-40, 2018-34 IRB 320, updating and modifying Rev. Proc. 2018-31 and Rev. Proc. 2017-30. Form 3115 must be attached to the return for the year of the change. Technically, the IRS is not required to accept the change and may notify the taxpayer that the change is rejected. In that event, the taxpayer must use the original method of accounting, submit a formal ruling request, and pay the applicable user fee.

124. IRC §1060(a)(2).

125. See also Treas. Reg. §1.338-6.

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The residual allocation method requires the allocation of consideration between the following classes of assets.[126]

Class I. Cash, deposits in banks, and similar items

Class II. Certificates of deposit, U.S. government securities, certain marketable stocks and securities, foreign currency, and similar items

Class III. Accounts receivable, assets a taxpayer marks-to-market at least annually for tax purposes, mortgages, and credit card receivables from customers that arise in the ordinary course of business

Class IV. Stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the tax year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business

Class V. All assets other than those assigned to any other class

Class VI. All §197 intangibles **except** goodwill and going concern value

Class VII. Goodwill and going concern value

Consideration is first allocated to Class I assets.[127] After the consideration is reduced by the amount allocated to Class I, it is allocated in the order shown above among Class II through Class VI assets in proportion to their fair market values (FMV) as of the purchase date. Any remaining unallocated consideration is assigned to the Class VII assets (i.e., goodwill and going concern value).

If the parties to an applicable asset acquisition agree in writing to allocate any part of the purchase price to the acquired assets or to the FMV of any of the transferred assets, §1060(a) specifies that the agreement is binding unless the IRS determines that the allocation or FMV is not appropriate. Deviation from the written agreement is permissible only if the taxpayer can establish that the agreement would be unenforceable under state contract law due to conditions such as mistake, undue influence, fraud, or duress.[128] However, the IRS may challenge a taxpayer's determination of the FMV of any asset by any appropriate method, taking into account all factors including any lack of adverse tax interests between the parties.

> **Note.** Both the seller and the buyer must file Form 8594, *Asset Acquisition Statement Under Section 1060*, with their returns for the tax year that includes the purchase date.

However, if the parties do not agree in writing to allocate any part of the purchase price to the acquired assets, then the residual method of §338(b)(5) and Treas. Reg. §1.338-6(b) determines the buyer's basis in, and the seller's gain or loss from, each of the transferred assets. Under this method, the acquired assets are categorized among seven different asset classes (cash and cash equivalents, actively traded personal property, debt instruments, inventory, other assets not in the foregoing classes, intangibles, goodwill, and going concern value) and the purchase price is allocated to the asset classes according to the priority established by the regulations.

There is a link between the purchase price allocation required by §1060 for an applicable asset acquisition and cost segregation. This is evidenced in post-transaction situations when the parties either forget or choose to disregard their contractual allocations, subsequently conduct an audit, and assign values to the acquired assets based on generally accepted accounting principles (GAAP), and report tax consequences using the newly determined values rather than the previously agreed-upon contractual allocations.

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126. Treas. Reg. §1.1060-1(a)(1).

127. Ibid.

128. See, e.g., *Comm'r v. Danielson,* 378 F.2d 771 (3rd Cir. 1967), *cert. den.,* 389 U.S. 858 (1967).

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For example, in *Peco Foods, Inc. & Subsidiaries v. Comm'r*,[129] the parent corporation, through two of its subsidiaries, acquired the assets of two poultry processing plants for approximately $38 million during the 1990s. Each agreement allocated the purchase price of the assets between the two subsidiaries and further allocated the price among various assets in accordance with allocation schedules in the contractual agreements, which depreciated the improved real property over 39 years. Later, the corporation arranged for a cost segregation analysis of the two plants, further subdividing certain acquired assets into subcomponents. The analysis determined subdividing these assets would entitle the corporation to additional depreciation expense of approximately $5.26 million by reclassifying portions of the real property as tangible personal property. The corporation filed a request for a change in accounting method and claimed depreciation on its tax returns in accordance with the cost segregation analysis. The corporation deducted negative IRC §481 adjustments and accelerated MACRS depreciation for the reclassified assets.

The IRS audited the parties' returns and disallowed the deductions based on the reclassifications. The Tax Court agreed, holding that, under §1060(a), the corporation was bound by the written allocation schedules that were agreed upon by the parties to the transaction. The Tax Court found no ambiguity in the original allocations that would warrant further subdividing the assets into subcomponents in accordance with the cost segregation study. Consequently, the Tax Court disallowed the accounting method change and required the corporation to claim depreciation in accordance with the original allocation schedules.

The Tax Court noted that its holding barred the government from being disadvantaged by inconsistent treatment of the parties to the transaction. In addition, even if there was no possibility of inconsistent tax treatment, the court reasoned that "binding Peco to the original... allocation schedule[s] prevents it from realizing a better tax consequence than the one it bargained for." The Tax Court's decision was affirmed on appeal.

Observation. There are two lessons learned from *Peco Foods*. **First,** taxpayers that have agreed in writing to certain purchase price allocations cannot unilaterally change the original allocations to achieve a better tax result. In accordance with §1060(a), taxpayers are bound by their original allocations of the purchase price or as to the FMV of any of the transferred assets, unless the IRS determines the allocation or FMV is not appropriate. **Second,** because both real property and depreciable tangible personal property are Class V assets and no further breakdown is required on Form 8594, the purchase price should not be allocated other than is necessary to ensure consistent reporting by the parties to the transaction on Form 8594. Allocation is by class, not by specific assets.

Potential Recapture Issue. When a component of §1250 property is reclassified as §1245 property, the total depreciation allowable on the reclassified item is the same. The benefit comes from the present value of the tax savings resulting from the acceleration of the depreciation deduction. However, depreciation recapture can occur on disposition. Depreciation on a §1245 asset is subject to ordinary income recapture and is ineligible for long-term capital gain treatment under IRC §1231. The impact of this result depends on the particular taxpayer's marginal tax rate at the time the recaptured amount is taxed. If the item of property had not been reclassified, gain would have been subject to a maximum rate of 25% as unrecaptured §1250 depreciation. On the other hand, the tax on recapture of ordinary income could be de minimis or it could be as high as 37% for individuals (but only 21% for C corporations).

129. *Peco Foods, Inc. & Subsidiaries v. Comm'r*, TC Memo 2012-18 (Jan. 17, 2012), *aff'd* 522 Fed. Appx. 840 (11th Cir. 2013).

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The recapture issue may be more problematic if the disposition of the reclassified asset is via installment sale, like-kind exchange, or involuntary conversion. Although gain from a sale of §1231 property can be reported on the installment basis, installment reporting is not permitted for §1245 depreciation recapture. Instead, **all §1245 recapture is treated as cash received in the year of sale** and must be reported at that time.[130] The taxpayer's basis in the property for purposes of calculating the gross profit ratio is then increased by the amount of depreciation recapture, and any remaining gain is taxed each year using the recomputed gross profit ratio.

Observation. In an installment sale, a taxpayer who has reclassified a significant portion of a property's basis as §1245 tangible personal property must ensure they receive a sufficient cash downpayment to pay the tax liability resulting from the recapture, along with any first-year payments. This may also lead to some creative purchase price allocations in sales contracts.

Ordinary income recapture under §1245 applies to any disposition of §1245 property, notwithstanding any other Code provision, unless there is an express exception contained in §1245.[131] IRC §1245(b)(4) provides a limited exception from the recapture rules for like-kind exchanges under §1031 and involuntary conversions under §1033. Under the exceptions, if property is disposed of and the gain is not recognized under §§1031 or 1033, then the amount of gain taken into account under §1245 by the seller cannot exceed the sum of the amounts of gain recognized on the disposition. Such gain is determined without regard to §1245 (effectively boot received under §1031 and proceeds not reinvested under §1033). In addition, the gain includes the FMV of any property received that is not §1245 property and has not already been taken into account as gain.

The applicable rules in the event a portion of the real property is reclassified as §1245 property are illustrated in the following example.[132]

Example 10. Sam owns §1245 property, with an adjusted basis of $100,000 and a recomputed basis of $116,000. The property is destroyed by fire, and Sam receives $117,000 of insurance proceeds, which triggers $16,000 of recapture.

Sam uses $105,000 of the proceeds to purchase §1245 property similar or related in service or use to his original property, and $9,000 of the proceeds to purchase stock to control a corporation owning property similar or related in service or use to Sam's original property. Both acquisitions qualify under the involuntary conversion rules. Sam properly elects to limit recognition of gain to the amount realized from the involuntary conversion less the cost of the stock and other property acquired to replace the converted property.

Sam is required to recognize gain of $3,000 (without regard to the §1245 recapture rules) under the involuntary conversion rules for failure to purchase sufficient replacement property ($117,000 insurance proceeds – $105,000 purchase of §1245 property – $9,000 stock purchase). Because the stock purchased for $9,000 is not §1245 property and was not taken into account in determining the gain under the involuntary conversion rules, the amount of the gain taken into account as §1245 recapture is limited to $12,000 ($3,000 + $9,000).

If, instead of purchasing $9,000 in stock, Sam purchased $9,000 of §1245 property that was similar or related in use to the destroyed property, the recapture amount would have been limited to $3,000.[133]

130. IRC §453(i).

131. IRC §1245(a)(1).

132. This example is based on Treas. Reg. §1.1245-4(d)(5) .

133. The result of this example would be similar in a §1031 exchange.

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As mentioned earlier, a building containing items reclassified as §1245 tangible personal property for MACRS purposes as the result of a cost segregation study does not change the classification of the property for purposes of the like-kind exchange provisions of §1031, or the involuntary conversion rules of §1033.

Example 11. As the result of a cost segregation study, Ray reclassifies 25% of the basis of items in a building as 7-year MACRS property and claims accelerated depreciation. **All of the items are otherwise structural components of the building and therefore remain classified as real property under state law.**

Ray later trades the building and associated land in a like-kind exchange for unimproved land. For purposes of applying the like-kind exchange rules of §1031, Ray is treated as having traded real property for real property. Ray, however, still recognizes gain under §1245 when the unimproved land is later disposed of to the extent of the §1245 property allocation (7-year MACRS property) in the relinquished asset that was exchanged for the unimproved land.[134]

IRS Field Directives

The IRS issued field directives for cost segregation issues in various industries that categorize many assets either as §1250 property or §1245 property. If a taxpayer takes a position on a return with respect to an asset that follows the guidance of the applicable directive, an IRS examining agent should not make adjustments to how the assets are categorized or the recovery period of the assets. Following is a list of the IRS field directives for various industries.

- The IRS cost segregation field directive for **casinos** can be found at **uofi.tax/19b4x2** [www.irs.gov/businesses/cost-segregation-atg-chapter-7-1-industry-specific-guidance-casinos].
- The IRS cost segregation field directive for **restaurants** can be found at **uofi.tax/19b4x3** [www.irs.gov/businesses/cost-segregation-guide-chapter-72-industry-specific-guidance-restaurants].
- The IRS cost segregation field directive for **retail industries** can be found at **uofi.tax/19b4x4** [www.irs.gov/businesses/cost-segregation-atg-chapter-7-3-industry-specific-guidance-retail-industries].
- The IRS cost segregation field directive for **pharmaceutical and biotechnology industries** can be found at **uofi.tax/19b4x5** [www.irs.gov/businesses/cost-segregation-audit-techniques-guide-chapter-74-industry-specific-guidance-pharmaceutical-and-biotechnology].
- The IRS cost segregation field directive for **auto dealers** can be found at **uofi.tax/19b4x6** [www.irs.gov/businesses/field-directive-on-the-planning-and-examination-of-cost-segregation-issues-in-the-auto-dealership-industry].
- The IRS cost segregation field directive for **auto manufacturing** can be found at **uofi.tax/19b4x7** [www.irs.gov/businesses/cost-segregation-audit-techniques-guide-chapter-7-6-auto-manufacturing].

Note. An IRS field directive is not an official pronouncement of the law, or the IRS's position. However, they are useful as a guide for classifying buildings that contain many potential §1245 assets. The fact that the directives deal with broad classifications of §1245 property also provides guidance for property not within an industry that is specifically covered by one of the directives.

134. IRC §§1245(a)(1)(B)(i) and 1250(a)(1)(A)(ii); Treas. Reg. §1.1245-1(b)(2).

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The directives list the following types of assets as having a shorter recovery period than applicable to §1250 property in general. Such property is eligible for bonus depreciation if otherwise qualified under §168(k).

- Canopies and awnings
- Decorative finished carpentry (detailed crown moldings, latticework on finished walls, ceiling, cabinets, etc.)
- Doors (such as those that are flexible, or are clear curtains, etc., that are installed to prevent accidents)
- Electrical outlets associated with a specific item of machinery or equipment
- Electrical connections associated with specific machinery or equipment
- Interior building facades not permanently attached
- Fire protection equipment
- Floor coverings that are not permanently attached
- Foundations (such as footings to a building or for a sign or light pole)
- HVAC systems essential for the operation of other machinery
- Kiosks
- Landscaping and shrubbery
- Irrigation systems
- Decorative lighting not necessary for the operation of the building
- Lighting that highlights landscaping or the building exterior not related to the operation or maintenance of the building
- Exterior, pole-mounted lighting for sidewalks and parking
- Music or public-address system that is not part of a fire protection system
- Parking lot and associated items such as bumper blocks, curb cuts, perimeter fences, etc.[135]
- Light poles for parking
- Plumbing for appliances or equipment for a particular type of business (such as a restaurant or hair salon/barber shop)
- Security equipment
- Nonpermanent signs
- Site grading
- Moveable (partition) walls
- Nonpermanent wall coverings
- Window accessories

135. In Ltr. Rul. 9751010 (Sep. 12, 1997), the IRS took the position that an open-air parking ramp/tower consisting of an auto carousel mechanism and supporting tower is tangible personal property for purposes of §168. This type of structure could, perhaps, be contrasted with an open-air parking structure accessible by a ramp system, which might be 39-year MACRS property.

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Placed-In-Service

An asset is deemed to be placed in service when it is in a condition or state of readiness and available for a specifically assigned function, such as use in the taxpayer's trade or business.[136] For example, for a factory building the taxpayer constructs or reconstructs to house machinery and equipment, the building is deemed to be placed in service when it is substantially completed and in a condition or state of readiness and availability. It does not matter that the machinery and equipment has not been placed in the building. The only exceptions to this standard are when the building itself could be deemed to be an item of machinery or equipment, or the building use is so intertwined with the machinery or equipment that the building could be expected to be retired or replaced when the machinery or equipment it houses is retired or replaced.[137]

> **Observation.** Because of the depreciation incentives included in the TCJA, there are additional advantages to using cost segregation studies. In addition, it is even more important to know the correct placed-in-service date for assets.

Depreciation and Business Start Date. If a business asset is acquired before the business begins, depreciation deductions are not available until the business starts, regardless of whether the asset is ready and available for use in the business. A plan or intention of starting a business is not enough, and it is important to distinguish between an ongoing business that is idle and a future business that has not yet begun.[138]

The IRS may dispute the date the business actually began. In *Piggly Wiggly Southern, Inc. v. Comm'r*,[139] the petitioner, a grocery store, claimed depreciation on equipment it had in various grocery stores. Some of the stores were being renovated. Others were new stores. The court held the petitioner was not entitled to depreciation deductions attributable to equipment located in the new stores until those stores actually opened for business. The court noted the petitioner controlled when the new stores opened rather than external factors controlling when the stores opened. The court also pointed out that the equipment's cost could not be charged against any income until a new store was open for business.

In *Samadi v. Comm'r,*[140] the petitioner began investing in homes with friends and family. The group intended to buy homes, renovate them, and then sell them — a "fix and flip" strategy. The petitioner became a licensed real estate agent in 2010 and continued that licensing in 2013 and 2014, but earned no commissions from selling real estate in 2013 or 2014. He researched potential investment properties for the group and had access to properties that were for sale. The group never did more than merely look at real estate. However, they claimed auto mileage for driving to and from the same house, which was the home of the petitioner's brother and where a "client" lived, and for miles driven to take the client to look at a potential investment property. The IRS disallowed all deductions, taking the position that the petitioner had not yet begun operating a trade or business.

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136. See Treas. Reg. §1.167(a)-11(e)(1)(i). For case law on the specifically assigned function issue, see *Noell v. Comm'r,* 66 TC 718 (1976); *Consumers Power Co. v. Comm'r,* 89 TC 710 (1987); *Valley Natural Fuels v. Comm'r,* TC Memo 1991-341 (Jul. 25, 1991), *aff'd* 990 F.2d 1266 (9th Cir. 1993); and *Brown v. Comm'r,* TC Memo 2013-275 (Dec. 3, 2013). See also Treas. Regs. §§1.46-3(d)(1)(ii) and 1.46-3(d)(2); *Von Kalinowski v. Comm'r,* 45 F.3d 438 (9th Cir. 1994), *rev'g* TC Memo 1993-26; *Sears Oil Company, Inc. v. Comm'r,* 359 F.2d 191 (2d Cir. 1966).

137. Treas. Reg. §1.167(a)-11(e)(1)(i).

138. See, e.g., *Simonson v. U.S.,* 752 F.2d 341 (8th Cir. 1985); *Richmond Television Corp. v. U.S.,* 345 F.2d 901 (4th Cir. 1965).

139. *Piggly Wiggly Southern, Inc. v. Comm'r*, 803 F.2d 1572 (11th Cir. 1986).

140. *Samadi v. Comm'r,* TC Summ. Op. 2018-27 (May 24, 2018).

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The Tax Court agreed with the IRS. The Tax Court noted that merely having a real estate license is insufficient to create a trade or business of being a real estate agent. The petitioner did not continuously and regularly buy and sell real estate to clients. The Tax Court also noted the house-flipping business had not commenced in the years in question. The business was merely in the exploratory or formative stages. The Tax Court noted that carrying on a trade or business requires more than initial research into a potential business opportunity. Deductions are not allowed for startup or pre-opening expenses before business operations begin. The Tax Court noted that startup expenses cannot be claimed before the business begins. At that time, the expenses are either deducted or amortized over 180 months in accordance with IRC §195(b). If the business never starts, the expenses are not deductible.

> **Observation.** In practice, the determination of when an asset is placed in service is highly fact-dependent and can depend on the type of asset involved.

Commercial Buildings. The IRS tends to use the date on a certificate of occupancy as a factor in determining the placed-in-service date of a commercial building or a portion of the building. However, in *Stine, LLC v. U.S.,*[141] the court held that the two buildings of a retail operation at issue in the case were placed in service in the year when they were ready and available to store equipment and contained racks, shelving, and merchandise. The court viewed it as immaterial that the certificates of occupancy for the buildings did not allow public access until the next year. The placed-in-service date was important in *Stine* because the taxpayer sought to have the buildings placed in service in 2008 (rather than 2009) in order to be eligible to deduct Gulf Opportunity Zone bonus depreciation on the buildings.

> **Note.** The IRS issued a nonacquiescence in *Stine.*[142] The IRS said it will continue to litigate the placed-in-service issue on the basis of its position that a retail store is not placed in service until it is open for business.

For a building that is completed in sections, depreciation may be claimed on each section as it is completed and placed in service.[143] Thus, depreciation can be claimed on each section beginning at the time that section is completed and placed in service.[144]

Machinery and Equipment. The determination of when the placed-in-service requirement is satisfied is highly fact-specific for machinery and equipment.[145] Therefore, it is imperative for practitioners to obtain all necessary and relevant facts from clients to support the client's position taken on the return as to when depreciation deductions commence.

Cost Segregation Timing. Cost segregation studies performed contemporaneously in the tax year that qualified property is placed in service should allow enough time before the tax return is filed to determine the amount of bonus and other depreciation allowable on the property. On the other hand, when a cost segregation study is performed **after** the tax return is filed for the year that the qualified property is placed in service, it is unlikely that the taxpayer claimed bonus depreciation on that property and has been using an impermissible method of accounting. Generally, taxpayers can file an amended tax return for the property's placed-in-service year to claim bonus depreciation and adjust the depreciation allowable on the qualified property, provided they file an amended tax return before the taxpayer files its tax return for the first tax year succeeding the placed-in-service year. However, if the taxpayer files the tax return for the first tax year succeeding the placed-in-service year before the cost segregation study was performed and the qualified property was identified, the taxpayer has adopted an impermissible method of accounting and must change from an impermissible method to a permissible method by filing Form 3115.

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141. *Stine, LLC v. U.S.,* No. 2:13-03224, 2015 U.S. Dist. LEXIS 9850 (W.D. La. 2015).

142. AOD 2017-02 (Apr. 10, 2017).

143. Rev. Rul. 76-142, 1976-1 CB 8.

144. See, e.g., *St. Louis Malleable Casting Co. v. Comm'r,* 9 BTA 110 (1927).

145. *See, e.g.,* Rev. Rul. 84-85, 1984-1 CB 10; *Siskiyou Communications, Inc. v. Comm'r,* TC Memo 1990-429 (Aug. 8, 1990); FSA 1997-6; *Brown v. Comm'r,* TC Memo 2013-275 (Dec. 3, 2013); *Brown v. Comm'r,* TC Summ. Op. 2009-171 (Nov. 23, 2009).

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IRS Audit Approach

The IRS issued a very detailed audit techniques guide (ATG) concerning cost segregation studies.[146] The guide is useful in terms of the information it provides practitioners concerning the IRS's view on what constitutes a properly conducted cost segregation study. Approximately half of the ATG provides guidance on casinos, restaurants, retail industries, biotech and pharmaceutical industries, auto dealerships, electrical distribution systems, and stand-alone open-air parking structures. The balance of the ATG provides guidance to practitioners who have clients considering the use of a cost segregation study as well as those under IRS examination regarding such studies. The ATG is also useful to practitioners consider performing an in-house cost segregation study and provides guidance on what the IRS considers to be a quality study.

In the ATG, IRS auditors are advised to closely scrutinize cost segregation studies conducted on a contingency fee basis. The IRS believes such fee structures provide incentives to maximize §1245 costs through "aggressive legal interpretations" or by inappropriate cost or estimation techniques. As a result, firms performing cost segregation studies may be better off billing the work based on the size of the project plus out-of-pocket expenses. Auditors are also advised to conduct in-depth reviews of cost segregation studies to determine the appropriateness of property depreciation classifications and determine if there are any land or nondepreciable land improvements the study has classified as depreciable property.[147]

In the ATG, IRS examiners are advised to closely look at the classification of §§1245 and 1250 property. In making this distinction, taxpayer records and documentation are critical. The IRS looks to see whether a building component designated as §1245 property can actually be used for other pieces of equipment. If it can, it will likely be classified as part of the building. The ATG also notes that IRS examiners can use sales tax records of the taxpayer as guidance on the proper allocation between §§1245 and 1250 property. Other key points on the distinction between §§1245 and 1250 property involve whether the cost segregation study used cost estimates or actual cost records or a residual approach to determine the actual cost of §1245 items. The IRS tries to determine whether the cost of §1245 property has been set too high.

Another specific area of examination involves situations in which multiple items of depreciable and nondepreciable property are acquired for a lump sum. The ATG points out to examiners that the basis for depreciation cannot exceed an amount that bears the same proportion to the lump sum as the value of the depreciable property at the time of the acquisition bears to the value of the entire property at that time.[148] Examiners look at the FMVs of the properties at the time of acquisition. The FMV of land is based on its highest and best use as vacant land even if it has improvements on it. Accordingly, the ATG states it is not correct for a cost segregation study to estimate land value by subtracting the estimated value of improvements from the lump-sum acquisition price. Doing so, according to the IRS, results in an overstatement of the basis of depreciable improvements.

The ATG instructs examiners to reconcile total project costs (in terms of cost basis) in the taxpayer's records with the total project costs in the cost segregation study. The IRS can be expected to request a copy of the taxpayer's general ledger data. A key question is whether costs that should have been in the taxpayer's building account, for example, were classified in another account or were expensed. Likewise, the ATG states examiners should determine if costs associated with site preparation, grading, and land contouring were properly (in the IRS's view) allocated to land basis rather than being allocated to the overall building cost.

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146. See *Cost Segregation Audit Techniques Guide.* IRS. [www.irs.gov/businesses/cost-segregation-audit-techniques-guide-table-of-contents] Accessed on Jun. 26, 2019.

147. This could be a particularly important issue for cost segregation studies involving farm and ranch taxpayers.

148. See Treas. Reg. §1.167(a)-5.

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Possible Penalties

In 2018, the IRS released a chief counsel advice (CCA) taking the position that the preparers of cost segregation studies could be subjected to penalties.[149] The CCA involved a situation in which an engineer/consultant prepared a cost segregation study without having any direct role in preparing tax returns. The engineer/consultant simply provided the completed study to the taxpayer so the taxpayer could use it in the preparation of the taxpayer's returns. The cost segregation study divided a 39-year item of property into component parts, many of which were assigned 5-year MACRS lives. On audit, the IRS disagreed with the classification of structural building components as 5-year property. Simply correcting the improper classification on the taxpayer's returns was not enough.

The IRS took the position that IRC §6701 could serve as the basis for penalties against the study's preparer for aiding and abetting the understatement of tax liability. The IRS position was that the engineer/consultant, by preparing the cost segregation study, was aiding or advising in the preparation of the taxpayer's return, which satisfied §6701(a)(1). Accordingly, the engineer/consultant either knew or had reason to know the study would be used "in a material matter relative to the IRC," which satisfied §6701(a)(2). In addition, the IRS argued that the engineer/consultant had **actual knowledge** the cost segregation study would result in an "understatement of the tax liability of another person" under §6701(a)(3). This last point is important. If the preparer of a cost segregation study knows the study inflates depreciation deductions, which results in an understated tax liability, the preparer is liable for penalties because the first two elements of §6701 are satisfied.

The IRS determined that the engineer/consultant was liable for the $1,000 penalty for aiding and abetting the misstatement of individual tax forms. If a misstated corporate return was involved, the penalty would have been $10,000. **However, the IRS took the position that the $1,000 penalty should be imposed multiple times because the cost segregation study contributed to five returns misstating income as a result of the classification of 39-year property as 5-year property.** Why the IRS did not take the position that six $1,000 penalties should be imposed was not clear. Five-year MACRS property results in six years of depreciation deductions (one-half year's depreciation in year one and in year six under the half-year convention). The IRS cited *In re Mitchell*[150] to support its position that multiple penalties should be imposed.

Observation. The CCA indicates the IRS is looking to establish that a study author has actual knowledge (under the preponderance of the evidence standard) that the study would result in an understatement of tax liability.[151] Actual knowledge must be shown. If a cost segregation study is prepared in accordance with the general guidance of *Hospital Corporation of America & Subsidiaries v. Comm'r,* penalties should be avoided. However, ambiguities will likely exist on the distinction between §§1245 and 1250 property.[152]

Example 12. Darrin and Samantha live in Westport, Connecticut. They own an existing commercial building that they lease to multiple tenants. They purchased the property in January 2015 at a cost of $952,000. They met with their accountant, Larry Tate, to prepare their 2015 return. Larry explained there must be an allocation between the building and land because land is not a depreciable asset. Based on historical sales of similar property and county assessment records, all parties agreed to allocate $150,000 to the land and $802,000 to the building. Larry provided Darrin and Samantha with the following depreciation amounts for the next several years, assuming no improvements are made to the property.

149. CCA 201805001 (Oct. 26, 2017).

150. *In re Mitchell,* 977 F.2d 1318 (9th Cir. 1992).

151. See, e.g., *Mattingly v. U.S.,* 924 F.2d 785 (8th Cir. 1991).

152. *Hospital Corporation of America & Subsidiaries v. Comm'r,* 109 TC 21 (1997), *acq. and non-acq.* 1999-35 IRB 314, as corrected by Ann. 99-116, 1999-52 IRB 763.

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- **Year 1:** \$19,737 (\$802,000 depreciable basis × .02461[153] because the property was placed into service in January 2015)
- **Years 2–39:** \$20,563 (\$802,000 depreciable basis × .02564[154] applicable depreciation percentage)

As of the end of 2018, total depreciation deductions are as follows.

2015	\$19,737
2016	20,563
2017	20,563
2018	20,563
Total	\$81,426

In the summer of 2018, Samantha's Aunt Clara contacted them and explained that she had taken a job with a cost segregation service called Morning Glory Circle. She believed Darrin and Samantha could benefit from her services. After meeting and explaining the process of a cost segregation study, Clara stated that her fee would be \$5,250. Samantha thought that was too high, but Clara explained that you cannot simply twitch your nose and get this kind of work done.

Darrin and Samantha called Larry Tate to ask his opinion about having a cost segregation study performed. He said a cost segregation study is a waste of time because over the life of the property they would claim the same total depreciation deductions, perhaps just not as quickly. Darrin was concerned about his 2018 taxes because he anticipated a very large salary bonus after attracting many new clients to the advertising agency where he worked. Accordingly, Darrin and Samantha agreed to have the study performed.

Clara explained that there are two steps in the cost segregation process.

1. In the preliminary analysis and identification phase, Clara becomes familiar with the project, and begins the preliminary identification of potential asset categories under MACRS for Darrin and Samantha's commercial building.
2. After a physical inspection of the property, Clara segregates all the direct and indirect costs of the building into various depreciable lives.

Clara provided the following allocation of the original building property cost (\$802,000) to Darrin and Samantha, as supported by the company's study results for 2017.

Allocation to 5-year property	\$105,360
Allocation to 15-year property	37,629
Allocation to 39-year property	659,011
Total	\$802,000

Based on this allocation, Clara stated Darrin and Samantha will benefit from the 2018 depreciation deduction as follows.

	5-Year Property	15-Year Property
2015–2017 total depreciation	\$75,016	\$ 8,673
2018 depreciation	12,137	2,608
Total	\$87,153	\$11,281

153. IRS Pub. 946, *How To Depreciate Property,* p. 71 (2018).

154. Ibid.

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The total depreciation on 39-year property for 2015–2017 was $60,863 before the cost segregation study. After the study, the total depreciation for 39-year property is **$50,012,** for a reduction of $10,851. This is because the basis in 39-year property was reduced from $802,000 to $659,011.

As a result of the cost segregation study, Darrin and Samantha's negative §481(a) adjustment for tax years 2015–2017 is $72,838 ($75,016 depreciation for 5-year property + $8,673 depreciation for 15-year property – $10,851 reduction in 39-year property depreciation).

In addition to this one-time deduction, Darrin and Samatha's 2019 depreciation will be **$31,642,** as calculated in the following table.[155] It would have been $20,563 under the pre-cost segregation analysis.

	2019 Pre-Study Depreciation		2019 Post-Study Depreciation	
39-year property	$20,563	($802,000 × .02564)	$16,897	($659,011 × .02564)
15-year property			2,608	($37,629 × .0693)
5-year property			12,137	($105,360 × .1152)
Totals	$20,563		$31,642	

Clara explained that the negative §481(a) adjustment for the previous years can be deducted in full[156] in 2018. However, at some point in the future, the annual depreciation deduction will be lower than it would have been before the cost segregation study because more depreciation was deducted in the earlier years. Prior to the study, the annual depreciation would have been $20,563 (as shown earlier). In future years, once the 15-year and 5-year property are fully depreciated, the remaining 39-year annual depreciation will be $16,897. Darrin and Samantha decide they want a higher deduction in 2018.

Darrin was excited about the potential for a $72,838 deduction for 2018. Because Samantha qualifies as a real estate professional, the negative §481(a) adjustment is allowed in full in 2018, rather than being suspended under §469 as a passive loss. This could represent tax savings between federal and Connecticut tax of more than $24,000.

Given that Clara is new to the cost-segregation field, Darrin wants proof that Clara's numbers were not pulled out of thin air. Clara assured Darrin that she was correct and gave him a Schedule E and a Form 3115 with her company's report. Relevant portions of the forms follow.

SCHEDULE E (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Supplemental Income and Loss
(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)
▶ Attach to Form 1040, 1040NR, or Form 1041.
▶ Go to *www.irs.gov/ScheduleE* for instructions and the latest information.

OMB No. 1545-0074
2018
Attachment Sequence No. 13

Name(s) shown on return: **Darrin and Samantha Stephens**
Your social security number: **123-45-6789**

Part I **Income or Loss From Rental Real Estate and Royalties** **Note:** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see instructions). If you are an individual, report farm rental income or loss from Form 4835 on page 2, line 40

17	Utilities	17		
18	Depreciation expense or depletion	18		
19	Other (list) ▶ 481(a) ADJ SEE FORM 3115	19	72,838	00
20	Total expenses. Add lines 5 through 19	20		

... line 20 from line 3 (rents) and/or 4 (royalties). If ...

155. IRS Pub. 946, *How To Depreciate Property.*

156. Rev. Proc. 96-31, 1996-1 CB 714.

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For Example 12

Form **3115**
(Rev. December 2018)
Department of the Treasury
Internal Revenue Service

Application for Change in Accounting Method

▶ Go to *www.irs.gov/Form3115* for instructions and the latest information.

OMB No. 1545-2070

Name of filer (name of parent corporation if a consolidated group) (see instructions) Darrin Stephens Samantha Stephens	**Identification number** (see instructions) 123-45-6789 Principal business activity code number (see instructions)
Number, street, and room or suite no. If a P.O. box, see the instructions. 1164 Montgomery Ave	Tax year of change begins (MM/DD/YYYY) 01/01/2018 Tax year of change ends (MM/DD/YYYY) 12/31/2018
City or town, state, and ZIP code Westport CT 06880	Name of contact person (see instructions)
Name of applicant(s) (if different than filer) and identification number(s) (see instructions)	Contact person's telephone number

If the applicant is a member of a consolidated group, check this box . . . ▶ ☐

If **Form 2848,** Power of Attorney and Declaration of Representative, is attached (see instructions for when Form 2848 is required), check this box . . . ▶ ☐

Check the box to indicate the type of applicant.

- ☒ Individual
- ☐ Corporation
- ☐ Controlled foreign corporation (Sec. 957)
- ☐ 10/50 corporation (Sec. 904(d)(2)(E))
- ☐ Qualified personal service corporation (Sec. 448(d)(2))
- ☐ Exempt organization. Enter Code section ▶
- ☐ Cooperative (Sec. 1381)
- ☐ Partnership
- ☐ S corporation
- ☐ Insurance co. (Sec. 816(a))
- ☐ Insurance co. (Sec. 831)
- ☐ Other (specify) ▶

Check the appropriate box to indicate the type of accounting method change being requested. See instructions.

- ☒ Depreciation or Amortization
- ☐ Financial Products and/or Financial Activities of Financial Institutions
- ☐ Other (specify) ▶

Caution: To be eligible for approval of the requested change in method of accounting, the taxpayer must provide all information that is relevant to the taxpayer or to the taxpayer's requested change in method of accounting. This includes **(1)** all relevant information requested on this Form 3115 (including its instructions), and **(2)** any other relevant information, even if not specifically requested on Form 3115.
The taxpayer must attach all applicable statements requested throughout this form.

Part I Information for Automatic Change Request

		Yes	No
1	Enter the applicable designated automatic accounting method change number ("DCN") for the requested automatic change. Enter only one DCN, except as provided for in guidance published by the IRS. If the requested change has no DCN, check "Other," and provide both a description of the change and a citation of the IRS guidance providing the automatic change. See instructions.		
a	(1) DCN: 7 (2) DCN: (3) DCN: (4) DCN: (5) DCN: (6) DCN: (7) DCN: (8) DCN: (9) DCN: (10) DCN: (11) DCN: (12) DCN:		
b	Other ☐ Description ▶		
2	Do any of the eligibility rules restrict the applicant from filing the requested change using the automatic change procedures (see instructions)? If "Yes," attach an explanation.		×
3	Has the filer provided all the information and statements required **(a)** on this form and **(b)** by the List of Automatic Changes under which the applicant is requesting a change? See instructions. **Note:** Complete Part II and Part IV of this form, and, Schedules A through E, if applicable.	×	

Part II Information for All Requests

		Yes	No
4	During the tax year of change, did or will the applicant **(a)** cease to engage in the trade or business to which the requested change relates, or **(b)** terminate its existence? See instructions.		×
5	Is the applicant requesting to change to the principal method in the tax year of change under Regulations section 1.381(c)(4)-1(d)(1) or 1.381(c)(5)-1(d)(1)? If "No," go to line 6a. If "Yes," the applicant cannot file a Form 3115 for this change. See instructions.		×

Sign Here

Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

Signature of filer (and spouse, if joint return)	Date	Name and title (print or type)
		Darrin Stephens Samantha Stephens

Preparer (other than filer/applicant)

Print/Type preparer's name	Preparer's signature	Date

Firm's name ▶

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 19280E Form **3115** (Rev. 12-2018)

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For Example 12

Form 3115 (Rev. 12-2018) Page **2**

Part II Information for All Requests *(continued)*

		Yes	No
6a	Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any federal income tax return(s) under examination (see instructions)? If "No," go to line 7a.		×
b	Is the method of accounting the applicant is requesting to change an issue under consideration (with respect to either the applicant or any present or former consolidated group in which the applicant was a member during the applicable tax year(s))? See instructions.		
c	Enter the name and telephone number of the examining agent and the tax year(s) under examination. Name ▶ ______ Telephone number ▶ ______ Tax year(s) ▶ ______		
d	Has a copy of this Form 3115 been provided to the examining agent identified on line 6c?		
7a	Does audit protection apply to the applicant's requested change in method of accounting? See instructions. If "No," attach an explanation.	×	
b	If "Yes," check the applicable box and attach the required statement. ☒ Not under exam ☐ 3-month window ☐ 120 day: Date examination ended ▶ ______ ☐ Method not before director ☐ Negative adjustment ☐ CAP: Date member joined group ▶ ______ ☐ Audit protection at end of exam ☐ Other		
8a	Does the applicant (or any present or former consolidated group in which the applicant was a member during the applicable tax year(s)) have any federal income tax return(s) before Appeals and/or a federal court? If "No," go to line 9.		×
b	Is the method of accounting the applicant is requesting to change an issue under consideration by Appeals and/or a federal court (for either the applicant or any present or former consolidated group in which the applicant was a member for the tax year(s) the applicant was a member)? See instructions. If "Yes," attach an explanation.		
c	If "Yes," enter the name of the (check the box) ☐ Appeals officer and/or ☐ counsel for the government, telephone number, and the tax year(s) before Appeals and/or a federal court. Name ▶ ______ Telephone number ▶ ______ Tax year(s) ▶ ______		
d	Has a copy of this Form 3115 been provided to the Appeals officer and/or counsel for the government identified on line 8c?		
9	If the applicant answered "Yes" to line 6a and/or 8a with respect to any present or former consolidated group, attach a statement that provides each parent corporation's **(a)** name, **(b)** identification number, **(c)** address, and **(d)** tax year(s) during which the applicant was a member that is under examination, before an Appeals office, and/or before a federal court.		
10	If for federal income tax purposes, the applicant is either an entity (including a limited liability company) treated as a partnership or an S corporation, is it requesting a change from a method of accounting that is an issue under consideration in an examination, before Appeals, or before a federal court, with respect to a federal income tax return of a partner, member, or shareholder of that entity?		×
11a	Has the applicant, its predecessor, or a related party requested or made (under either an automatic or non-automatic change procedure) a change in method of accounting within any of the five tax years ending with the tax year of change? If "No," go to line 12.		×
b	If "Yes," for each trade or business, attach a description of each requested change in method of accounting (including the tax year of change) and state whether the applicant received consent.		
c	If any application was withdrawn, not perfected, or denied, or if a Consent Agreement granting a change was not signed and returned to the IRS, or the change was not made or not made in the requested year of change, attach an explanation.		
12	Does the applicant, its predecessor, or a related party currently have pending any request (including any concurrently filed request) for a private letter ruling, change in method of accounting, or technical advice?		×
	If "Yes," for each request attach a statement providing **(a)** the name(s) of the taxpayer, **(b)** identification number(s), **(c)** the type of request (private letter ruling, change in method of accounting, or technical advice), and **(d)** the specific issue(s) in the request(s).		
13	Is the applicant requesting to change its **overall** method of accounting? If "Yes," complete Schedule A on page 4 of the form.		

Form **3115** (Rev. 12-2018)

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For Example 12

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Part II Information for All Requests *(continued)*	Yes	No
14 If the applicant is either **(i) not** changing its overall method of accounting, or **(ii)** changing its overall method of accounting **and** changing to a special method of accounting for one or more items, attach a detailed and complete description for each of the following (see instructions):		
a The item(s) being changed.		
b The applicant's present method for the item(s) being changed.		
c The applicant's proposed method for the item(s) being changed.		
d The applicant's present overall method of accounting (cash, accrual, or hybrid).		
15a Attach a detailed and complete description of the applicant's trade(s) or business(es). See section 446(d).		
b If the applicant has more than one trade or business, as defined in Regulations section 1.446-1(d), describe **(i)** whether each trade or business is accounted for separately; **(ii)** the goods and services provided by each trade or business and any other types of activities engaged in that generate gross income; **(iii)** the overall method of accounting for each trade or business; and **(iv)** which trade or business is requesting to change its accounting method as part of this application or a separate application.		
Note: If you are requesting an automatic method change, see the instructions to see if you are required to complete lines 16a–16c.		
16a Attach a full explanation of the legal basis supporting the proposed method for the item being changed. Include a detailed and complete description of the facts that explains how the law specifically applies to the applicant's situation and that demonstrates that the applicant is authorized to use the proposed method.		
b Include all authority (statutes, regulations, published rulings, court cases, etc.) supporting the proposed method.		
c Include either a discussion of the contrary authorities or a statement that no contrary authority exists.		
17 Will the proposed method of accounting be used for the applicant's books and records and financial statements? For insurance companies, see the instructions.		
If "No," attach an explanation.		
18 Does the applicant request a conference with the IRS National Office if the IRS National Office proposes an adverse response?	×	

...ant is changing to either the overall cash method, an overall accrual method, or is chang...

Form 3115 (Rev. 12-2018) Page 4

Part IV Section 481(a) Adjustment	Yes	No
25 Does published guidance require the applicant (or permit the applicant and the applicant is electing) to implement the requested change in method of accounting on a cut-off basis?		
If "Yes," attach an explanation and do not complete lines 26, 27, and 28 below.		
26 Enter the section 481(a) adjustment. Indicate whether the adjustment is an increase (+) or a decrease (-) in income. ▶ $ **-72,838** Attach a summary of the computation and an explanation of the methodology used to determine the section 481(a) adjustment. If it is based on more than one component, show the computation for each component. If more than one applicant is applying for the method change on the application, attach a list of the **(a)** name, **(b)** identification number, and **(c)** the amount of the section 481(a) adjustment attributable to each applicant.		
27 Is the applicant making an election to take the entire amount of the adjustment into account in the tax year of change?		
If "Yes," check the box for the applicable elective provision used to make the election (see instructions). ☐ $50,000 de minimis election ☐ Eligible acquisition transaction election		
28 Is any part of the section 481(a) adjustment attributable to transactions between members of an affiliated group, a consolidated group, a controlled group, or other related parties?		×
If "Yes," attach an explanation.		

...ange in Overall Method of Accounting (If Schedule A applies, Part I below ... ted.)

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For Example 12

Part III Method of Cost Allocation *(continued)* See instructions.

Section C—Other Costs Not Required To Be Allocated (Complete Section C only if the applicant is requesting to change its method for these costs.)

		Present method	Proposed method
1	Marketing, selling, advertising, and distribution expenses		
2	Research and experimental expenses not included in Section B, line 26		
3	Bidding expenses not included in Section B, line 22		
4	General and administrative costs not included in Section B		
5	Income taxes		
6	Cost of strikes		
7	Warranty and product liability costs		
8	Section 179 costs		
9	On-site storage		
10	Depreciation, amortization, and cost recovery allowance not included in Section B, line 11		
11	Other costs (Attach a list of these costs.)		

Schedule E—Change in Depreciation or Amortization. See instructions.

Applicants requesting approval to change their method of accounting for depreciation or amortization complete this section. Applicants ***must*** provide this information for each item or class of property for which a change is requested.

Note: See the ***Summary of the List of Automatic Accounting Method Changes*** in the instructions for information regarding automatic changes under sections 56, 167, 168, 197, 1400I, 1400L, or former section 168. **Do not** file Form 3115 with respect to certain late elections and election revocations. See instructions.

1 Is depreciation for the property determined under Regulations section 1.167(a)-11 (CLADR)? ☐ **Yes** ☒ **No**
If "Yes," the only changes permitted are under Regulations section 1.167(a)-11(c)(1)(iii).

2 Is any of the depreciation or amortization required to be capitalized under any Code section, such as section 263A? ☐ **Yes** ☒ **No**
If "Yes," enter the applicable section ▶ ____________

3 Has a depreciation, amortization, expense, or disposition election been made for the property, such as the election under sections 168(f)(1), 168(i)(4), 179, 179C, or Regulations section 1.168(i)-8(d)? ☐ **Yes** ☒ **No**
If "Yes," state the election made ▶ ____________

4a To the extent not already provided, attach a statement describing the property subject to the change. Include in the description the type of property, the year the property was placed in service, and the property's use in the applicant's trade or business or income-producing activity.

b If the property is residential rental property, did the applicant live in the property before renting it? ☐ **Yes** ☐ **No**

c Is the property public utility property? ☐ **Yes** ☒ **No**

5 To the extent not already provided in the applicant's description of its present method, attach a statement explaining how the property is treated under the applicant's present method (for example, depreciable property, inventory property, supplies under Regulations section 1.162-3, nondepreciable section 263(a) property, property deductible as a current expense, etc.).

6 If the property is not currently treated as depreciable or amortizable property, attach a statement of the facts supporting the proposed change to depreciate or amortize the property.

7 If the property is currently treated and/or will be treated as depreciable or amortizable property, provide the following information for both the present (if applicable) and proposed methods:

a The Code section under which the property is or will be depreciated or amortized (for example, section 168(g)).

b The applicable asset class from Rev. Proc. 87-56, 1987-2 C.B. 674, for each asset depreciated under section 168 (MACRS) or under section 1400L; the applicable asset class from Rev. Proc. 83-35, 1983-1 C.B. 745, for each asset depreciated under former section 168 (ACRS); an explanation why no asset class is identified for each asset for which an asset class has not been identified by the applicant.

c The facts to support the asset class for the proposed method.

d The depreciation or amortization method of the property, including the applicable Code section (for example, 200% declining balance method under section 168(b)(1)).

e The useful life, recovery period, or amortization period of the property.

f The applicable convention of the property.

g Whether the additional first-year special depreciation allowance (for example, as provided by section 168(k), 168(l), 168(m), 168(n), 1400L(b), or 1400N(d)) was or will be claimed for the property. If not, also provide an explanation as to why no special depreciation allowance was or will be claimed.

h Whether the property was or will be in a single asset account, a multiple asset account, or a general asset account.

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For Example 12

ATTACHMENT TO FORM 3115

TAX YEAR 2018

Form 3115, Application For Change In Accounting Method, Impermissible to Permissible Method of Accounting for Depreciation or Amortization, Automatic Method DCN 7

This Form 3115 is being filed to change our tax method regarding the treatment of certain class lives. The applicable automatic method change is #7, which is changing from impermissible to permissible method of accounting for depreciation or amortization. This form is filed in accordance with Rev. Proc. 2015-14, Section 6.01, which is entitled "Impermissible to permissible method of accounting for depreciation or amortization."

Part IV, Line 26

39-Year Property		**15-Year Property**	**5-Year Property**
Actual depreciation claimed:			
$802,000 depreciable basis MACRS non-res real prop. S/L mid-month Date placed in service: January 2015		$0 depreciable basis 15YR MACRS 150% DB HY	$0 depreciable basis 5YR MACRS 200% DB HY
2015	$19,737	$ 0	$ 0
2016	20,563	0	0
2017	20,563	0	0
Total	$60,863		
Correct depreciation per cost segregation study cost detail report:			
$659,011 depreciable basis MACRS non-res real prop. S/L mid-month		$37,629 depreciable basis 15YR MACRS 150% DB HY	$105,360 depreciable basis 5 YR MACRS 200% DB HY
2015	$16,218	$1,881	$21,072
2016	16,897	3,575	33,715
2017	16,897	3,217	20,229
Total	$50,012	$8,673	$75,016

Total correct depreciation: $133,701 ($50,012 + $8,673 + $75,016)

Total §481(a) adjustment: ($72,838) ($133,701 correct depreciation – $60,863 originally claimed)

Note. For more information about the process of requesting a change in accounting method, including the Form 3115 requirements and §481(a) adjustments, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Small Business Issues.

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LIKE-KIND EXCHANGES[157]

Note. The TCJA eliminated tax-deferred like-kind exchanges of personal property for exchanges completed after 2017. However, exchanges of real estate can still qualify for tax-deferred treatment if the exchange involves real estate that is "like-kind."[158]

DEFINITION OF REAL ESTATE

4

Under the former rules governing trades of personal property, the Treasury regulations determined if property was like-kind by reference to whether it was within the same product class.[159] In addition, property was of a like-kind to property that was of the same nature or character.[160] However, like-kind personal property did not necessarily have to be of the same grade or quality.[161] Moreover, for intangible assets, the determination of like-kind had to be made on an asset-by-asset basis.[162]

With respect to real estate, a much broader definition of like-kind applies. Virtually any real estate used for business or investment can be exchanged for any other real estate if the taxpayer continues to use the replacement property for business or investment.[163] For real estate, the regulations also define "like-kind" in terms of reference to the nature or character of the replacement property rather than its grade or quality.[164]

The following are examples of qualifying like-kind exchanges involving the exchange of like-kind property that is of a different grade or quality.[165]

- Improved real estate for unimproved real estate
- Urban lots for rural tracts
- Commercial real estate for residential rental or investment real estate
- A leasehold or similar real property interest with at least 30 years left to run for fee simple real property

Deferred Like-Kind Exchanges[166]

Taxpayers may complete a deferred or reverse-Starker exchange that involves depreciable tangible personal property or intangible and nondepreciable personal property within the 45-day and the 180-day exchange deadlines.

The taxpayer is required to identify replacement property within 45 days after the transfer of the relinquished property.

The taxpayer must receive the replacement property by the earlier of:

- 180 days from the date the surrendered property is transferred, and
- The due date (including extensions) of the taxpayer's return for the tax year in which the first property is surrendered.

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157. IRC §1031.
158. TCJA §13303.
159. Treas. Reg. §1.1031(a)-2(b).
160. Treas. Reg. §1.1031(a)-1(b).
161. Ibid.
162. Treas. Reg. §1.1031(a)-2(c).
163. IRC §1031(a)(1).
164. Treas. Reg. §1.1031(a)-1(b); see also CCM 201238027 (Apr. 17, 2012).
165. Treas. Reg. §1.1031(a)-1; IRS Pub. 544, *Sales and Other Dispositions of Assets.*
166. Treas. Reg. §1.1031(k)-1; IRS Pub. 544, *Sales and Other Dispositions of Assets.*

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In addition, it does not matter whether the real estate involved in a tax-deferred exchange is improved or unimproved.[167] Thus, agricultural land may be traded for residential real estate. However, if bare land is traded for land with depreciable structures on it, tax issues can arise. Some depreciable buildings and structures may be "IRC §1245 property." If property with a §1245 depreciation recapture attribute is disposed of in a §1031 exchange, the amount of the gain recharacterized as ordinary income is recognized up to the amount of the boot received.[168] IRS Form 8824, *Like-Kind Exchanges,* provides a means for reporting the §1245 depreciation recapture if non-IRC §1245 property is received in the exchange.

> **Note.** For a detailed discussion of the pre- and post-TCJA like-kind exchange rules, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues.

CASE LAW

While the definition of real estate is rather broad, some distinctions exist. For example, a leasehold interest can be exchanged for fee interests if the leasehold interest has at least 30 years to run at the time the exchange is entered into.[169] Case law also indicates that, at the time the transaction is entered into, the lease must have at least 30 years remaining.[170]

The 30-year rule is important. The IRS has, apparently, taken the position that an exchange of a remainder interest in a tract of real estate for a life estate (when the life expectancy of the life tenant exceeds 30 years) for another tract of real estate can qualify for like-kind exchange treatment.[171] Likewise, a remainder interest in real estate can qualify for like-kind exchange treatment when it is exchanged for a remainder interest (or, probably, a reversionary interest) in a different tract of farmland.[172] In addition, real estate owned in fee simple can qualify for like-kind exchange treatment when traded for real estate subject to 99-year leases.[173]

A sale followed by a leaseback involving terms of 30 years or more has been deemed to be like-kind.[174]

As for land that is being sold under an installment land contract, the buyer's rights under the contract have been held to be the same as a fee simple interest in the real estate.[175]

IMPACT OF STATE LAW

State law plays a role in determining whether a property interest is an interest in real property that can potentially be eligible for like-kind exchange treatment. That was certainly the case in the early cases dealing with the issue.[176] However, other cases indicate that the like-kind determination is a matter of federal law rather than state law.[177]

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167. Treas. Reg. §1.1031(a)-1(b), (c)
168. IRC §1245(b)(4).
169. Treas. Reg. §1.1031(a)-1(c).
170. See, e.g., *VIP Industries Inc. & Subsidiaries v. Comm'r,* TC Memo 2013-157 (Jun. 24, 2013).
171. Rev. Rul. 72-601, 1972-2 CB 467.
172. Rev. Rul. 78-4, 1978-1 CB 256.
173. See, e.g. *Koch v. Comm'r,* 71 TC 54 (1978).
174. Rev. Rul. 60-43, 1960-1 CB 687; *Jordan Marsh Company v. Comm'r*, 269 F.2d 453 (2d Cir. 1959).
175. See, e.g., *Starker v. U.S.,* 602 F.2d 1341 (9th Cir. 1979).
176. See, e.g., *Morgan v. Comm'r*, 309 U.S. 78 (1940); *Aguilino v. U.S.,* 363 U.S. 509 (1960); *Comm'r v. Crichton,* 122 F.2d 181 (5th Cir. 1941); Ltr. Rul. 200424001 (Dec. 8, 2003).
177. See, e.g., *Fleming v. Comm'r,* 24 TC 818 (1955), *rev'd* 241 F.2d 78 (5th Cir. 1957).

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In 2012, the IRS clarified its position on the impact of state law in determining whether a property interest is an interest in real property. The IRS determined that federal income tax law, not state law, controls whether exchanged properties are of like kind for §1031 purposes.[178] While the IRS stated that state law property classifications are relevant for determining if property is real or personal, they are not determinative of whether properties are of the same nature and character. Instead, that determination is to be made by considering all of the facts and circumstances of the particular transaction and the property interests involved.[179]

CHARACTER OF LAND SALE GAIN

Is the gain on the sale of land taxed as capital gain (preferential rate) or as ordinary income? As with most tax questions, the answer is "it depends." Typically, when land is sold, the resulting gain or loss is capital in nature. However, there are situations in which the gain is ordinary in nature—particularly when undeveloped land is subdivided or sold off in smaller tracts (discussed later). Does selling the land in smaller tracts or subdividing it create ordinary gain rather than capital gain? That question invokes the issue of how "capital asset" is defined and whether a safe harbor applies.

CAPITAL ASSET OR INVENTORY CLASSIFICATION

IRC §1221(a) broadly defines the term **capital asset** as all property held by the taxpayer. Eight exceptions from that broad definition are provided.[180] The first exception, in §1221(a)(1), states a capital asset does not include "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." Therefore, property that is inventory or like inventory does not qualify as a capital asset.

Whether a landowner holds land primarily for sale to customers depends on the facts. As the U.S. Circuit Court of Appeals for the Tenth Circuit put it in the classic case of *Mauldin v. Comm'r*,[181] "[t]here is no fixed formula or rule of thumb for determining whether property sold by the taxpayer was held by him primarily for sale to customers in the ordinary course of his trade or business. **Each case must, in the last analysis, rest upon its own facts."**[182]

> **Example 13.** Greg, a successful general contractor, makes an appointment with Megan, who is a well-regarded CPA. Greg tells Megan he is unhappy with Joe, his previous tax professional, because he did not provide Greg with straight answers. Joe made Greg capitalize all of the development expenses he incurred in 2017 when he created a subdivision of 25 lots. When the lots are sold, the income will be treated as ordinary income instead of receiving capital gain treatment. Greg's brother-in-law, Craig, told him he read that if you hold property for investment and then sell it, it should be a capital gain instead of ordinary income.
>
> Greg tells Megan he owns another 50 acres adjacent to the subdivision, which he has not subdivided or improved in any way because he does not know what he wants to do with it just yet. Craig has now expressed an interest in buying it. Greg does not understand why the sale of the 25 lots would generate ordinary income while the sale of the adjacent 50 acres could be a capital gain.

The following discussion and court cases may be helpful in determining the proper answer to the issues raised in this example.

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178. CCA 201238027 (Sep. 21, 2012).

179. Ibid.

180. IRC §§1221(a)(1)–(8).

181. *Mauldin v. Comm'r*, 195 F.2d 714 (10th Cir. 1952).

182. The Fifth Circuit said essentially the same thing in *Suburban Realty Co. v. U.S.,* 615 F.2d 171 (5th Cir. 1980).

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REAL ESTATE BUSINESS

For a taxpayer engaged in real property trades or businesses, gains and losses are ordinary in nature. This often requires frequent sales of real estate and similar activity amounting to more than simply an intent to develop the property. For example, in *Evans v. Comm'r,*[183] the taxpayer's business plan was to acquire properties and tear down the structures on the properties and then build single and multi-unit residences for resale or rent the units out. However, from 2003–2007, the petitioner bought only one rental property and two other properties on which he tore down the existing structures. On one of the "tear-down" tracts, he constructed a 2-condominium building and then sold it. On the other "tear-down" property, he incurred developmental costs, borrowing money to do so. However, the taxpayer defaulted on the loan and the property went into foreclosure.

The taxpayer attempted to fully deduct his loss on the property as an ordinary loss from a real estate trade or business. **The IRS and the court disagreed**. The court noted the intent to develop property is not enough, by itself, to determine that a taxpayer is in real property trades or businesses. The court held that, to receive ordinary loss treatment, sales activity must be frequent and continuous rather than sporadic. In addition, the court determined that an inadequate number of properties was involved and the taxpayer's primary source of income was not from real estate activities. Moreover, the court noted the petitioner did not keep good business records.

> **Observation.** In **Example 13,** Greg's activity appears to rise to the level of real property trades or businesses with regard to his potential sale of the **25 subdivision lots,** which will likely generate ordinary income (or loss). The factors in *Evans* seem to indicate Greg's **50 acres** would not be ordinary business property because he lacks intent as to what he will do with the property. In *Evans,* the plaintiff sought ordinary loss treatment but that was not permitted. Greg could use the court's reasoning in *Evans* to his advantage with regard to the 50 acres being treated as investment property because he has not developed the acreage. As the court in *Evans* noted, the intent to develop property is not enough, by itself, to determine that a taxpayer is in real property trades or businesses. Therefore, if he **does** sell the 50 acres to Craig, it may be reasonable to conclude the property was held for investment.

Subdividing Real Estate

When property is subdivided and then sold, the IRS may assert the property was held for sale to customers in the ordinary course of the taxpayer's trade or business. If that argument holds, the gain generates ordinary income rather than capital gain income. However, IRC §1237 provides (at least) a partial safe harbor that allows a taxpayer who is not otherwise a dealer to dispose of a tract of real property, held for investment purposes, by subdividing it without necessarily being treated as a real estate dealer.[184] If the provision applies, the taxpayer is not treated as a dealer simply because the property was subdivided in an attempt to sell all or a part of it.

> **Observation.** Greg from **Example 13** would not be entitled to the provisions of §1237 because he had 25 lots for sale in the normal course of his trade or business. Moreover, Greg may be considered a dealer, which is discussed next.

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183. *Evans v. Comm'r,* TC Memo 2016-7 (Jan. 11, 2016).

184. See IRC §1237(a).

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What is a Dealer? Subdividing land does not necessarily cause a taxpayer to be classified as a "dealer" in real estate, with gains on sales taxed as ordinary income. Classification as a dealer depends on whether property is held primarily for sale to customers in the ordinary course of the taxpayer's business. Factors that the courts have examined in this regard include the following.[185]

1. The purpose for which the property was initially acquired
2. The purpose for which the property was subsequently held
3. The extent to which improvements, if any, were made to the property by the taxpayer
4. The frequency, number, and continuity of sales
5. The extent and nature of the transactions involved
6. The ordinary business of the taxpayer
7. The extent of advertising, promotion, or other active efforts used in soliciting buyers for the sale of the property
8. The listing of the property with brokers
9. The purpose for which the property was held at the time of sale

In addition, it is possible a real estate dealer may be classified as an investor with respect to some properties sold and receive capital gain treatment on investment properties. For other tracts, as indicated in *Murray v. Comm'r,* the dealer could be in the business of selling real estate, with the sale proceeds taxed as ordinary income.[186]

> **Observation.** Greg from **Example 13** would appear to have been engaged in the business of selling real estate based on the definition provided above. The *Murray* case seems to support capital gain treatment for Greg as an investor with regard to the 50 acres he holds.

The Safe Harbor. IRC §1237 specifies that gain from the sale or exchange of **up to five lots sold** from a tract of land can be eligible for capital gain treatment. The sale or exchange of additional lots results in some ordinary income. To qualify for the safe harbor, both the taxpayer and the property must meet the requirements of §1237, and the taxpayer must make an election to have the safe harbor apply.

> **Note.** The §1237 safe harbor only applies if there is a question of whether capital gain treatment applies. If capital gain treatment undoubtedly applies, §1237 is not invoked.[187]

For property to qualify for the safe harbor, the following requirements must be satisfied.[188]

- The taxpayer must not have previously held the property primarily for sale to customers in the ordinary course of business.
- In the year of sale, the taxpayer must not hold other real estate for sale as ordinary income property.
- The taxpayer has not made any substantial improvement to the property that considerably enhances the property's value.[189]
- The taxpayer must have held the property for at least five years.

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185. See, e.g., *Pritchett v. Comm'r,* 63 TC 149 (1974).
186. See, e.g., *Murray v. Comm'r,* 370 F.2d 568 (4th Cir. 1967).
187. See, e.g., *Gordy v. Comm'r,* 36 TC 855 (1961).
188. IRC §1237(a).
189. IRC §1237(b)(3); Treas. Reg. §1.1237-1(c).

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If the requirements are satisfied, the taxpayer can elect to have the safe harbor apply by submitting a plat of the subdivision, listing all of the improvements, and providing an election statement with the return for the year in which the lots covered by the election were sold.[190]

C corporations do not qualify for the §1237 election. This is because C corporations typically do not separate ordinary income from capital gain income. The C corporation's tax rate (21%) applies to the full amount of their capital gains but the corporation may only use capital losses to offset capital gains, not other kinds of income.[191]

Recent Case. In *Sugar Land Ranch Development, LLC v. Comm'r,*[192] the taxpayers formed a partnership in 1998 to buy and develop land outside of Houston for the purpose of turning that land into housing developments and commercial developments. The partnership acquired various parcels of land totaling approximately 950 acres. The land was a former oil field and, over the years, the partnership cleaned up the land, built a levee, and entered into a development contract with the city of Sugar Land, Texas, to set up the rules for developing the lots.

By 2008, the partnership completed a substantial amount of work developing the land. Then, the downturn in the real estate market hit and the partnership did not perform any further work on the property. It was not until 2012 that the partnership sold any significant part of the land. In that year, it sold two parcels (about 530 acres) to a homebuilding company. The homebuilding company paid a lump sum for each parcel and also agreed to make future payments relating to the expected development. A flat fee was paid for each plat recorded, and the homebuilding company paid 2% of the final sales price of each house developed on one of the parcels.

The partners entered into a "unanimous consent" agreement dated December 16, 2008, declaring the partnership would no longer attempt to develop the land but would instead hold the land until the real estate market recovered enough to sell at a profit.

The partnership reported an $11 million gain from the sale of one parcel and a $1.6 million loss on the other parcel. It took the position that the land that was sold was a "capital asset" and therefore the gains and losses were capital in nature. The IRS disagreed. It pointed out that the partnership acquired the property to develop it and merely delayed doing so because of the economic downturn.

Ultimately, the Tax Court agreed that the partnership had successfully changed its operations after 2008 from "developer" to "investor," such that the land it sold in 2012 was a capital asset and the gain was a capital gain. This significantly changed the tax liability.

> **Observation.** The partnership in *Sugar Land Ranch Development, LLC* never actually subdivided the property at issue into separate lots, and the IRS still claimed it was acquired and held for development purposes. While capital gain classification is based on a facts-and-circumstances test, subdividing land for sale does not necessarily mean it is no longer a capital asset. That is the point of §1237 and the safe harbor. In addition, the reason for holding property can change over time which, in turn, can change the tax result.

190. Treas. Reg. §1.1237-1(c)(iii)

191. IRC §§11(b) and 1212(a)(1).

192. *Sugar Land Ranch Development, LLC v. Comm'r,* TC Memo 2018-21 (Feb. 22, 2018).

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RECENT REAL ESTATE TAX CASES

NATURE OF INCOME: CAPITAL OR ORDINARY?

Loss was Capital — No Trade or Business Activity

In *Keefe v. Comm'r,*[193] the taxpayer owned an historic waterfront mansion and was in the process of restoring it, with plans to rent it. The restoration turned out to be more costly and took longer than originally anticipated. The taxpayer never actually rented the property even though a listing agent talked to prospective renters who expressed interest in renting it. Ultimately, the taxpayer abandoned attempts to rent the property due to economic issues and entered into a short sale of the property for $6.5 million.

On the taxpayer's 2009 return, the 7-figure loss on the sale was reported as a capital loss limited to $3,000 per year. Later, the petitioner met with an estate planner who questioned the tax treatment of the loss on the 2009 return. After this meeting, the taxpayer hired another tax preparer to file an amended 2009 return to treat the transaction as the sale of a §1231 asset. This treatment made the loss ordinary in nature, triggering a large net operating loss (NOL) that the petitioner carried back to 2004 and forward to 2010.

The IRS issued a refund but later examined the 2009 return and determined the loss was not a §1231 loss. Instead, the IRS classified it as a sale of a capital asset generating a capital loss. The Tax Court agreed with the IRS, noting that for property to be treated as property used in a taxpayer's trade or business, the taxpayer must be engaged in the activity on a basis that is, "continuous, regular, and substantial" in relation to the management of the property as part of the rental activity. The Tax Court noted that the taxpayer never engaged in any rental activity in a meaningful or substantial way. Thus, the IRS was correct to disallow the NOL carryover and carryback.

Note. The Tax Court also sustained the imposition of an accuracy-related penalty for the taxpayer's failure to rely on the advice of a professional. The Tax Court noted the taxpayer knew that they had never engaged in a rental activity.

Developer Gets Mixed Tax Results

In *Conner v. Comm'r,*[194] the petitioner was engaged in the business of building custom homes and then selling them to buyers via the petitioner's S corporation. The S corporation owned large tracts of undeveloped land that it bought for speculative purposes and did not use in its business operations or hold as inventory. The petitioner was also the sole owner of several LLCs through which he acquired additional tracts of undeveloped land. The petitioner's wife also held property for rental purposes via an LLC that she transferred to the petitioner. The petitioner elected to treat all rental activities as a single activity under IRC §469(c)(7)(A).

In 2013, the petitioner sold one property at a loss of approximately $2 million. The petitioner had planned to develop the property, but due to changed circumstances, did not proceed past the planning stages. The petitioner reported the income and expense associated with the property on Schedule C and fully deducted the resulting loss. The IRS recharacterized the gross receipts as investment income on Schedule E and disallowed the associated cost of goods sold deduction. The court agreed with the IRS, noting that the facts indicated capital loss treatment, particularly because the petitioner had placed the land in a conservation program that barred development.

193. *Keefe v. Comm'r,* TC Memo 2018-28 (Mar. 15, 2018).

194. *Conner v. Comm'r,* TC Memo 2018-6 (Jan. 22, 2018).

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The petitioner also incurred expenses associated with another property he had planned to develop but which never progressed beyond the planning stage. The petitioner deducted the expenses associated with this property on Schedule C, but the IRS moved them to Schedule A, where they were subject to the 2%-of-AGI limitation. The court agreed with the IRS that the expenses were deductible as investment expenses limited by IRC §163(d)(1).

On two other tracts, the IRS recharacterized the petitioner's reporting of rental income as investment income and allowed investment expenses.

The petitioner also reported a §1231 loss of $747,000 on the sale of depreciable business property from his S corporation that he reported on Form 4797, *Sales of Business Property,* which the IRS disallowed. The court allowed the $747,000 loss on the property.

The IRS denied losses associated with another tract under the passive loss rules of §469. The IRS also disallowed an NOL carryforward under §469.

For all of the various LLCs, the court determined the properties were held for investment and the grouping election did not result in a trade or business for the combined properties. Moreover, the petitioner did not satisfy the material participation requirement of §469 with respect to the LLCs. The court also sustained the IRS's determination with respect to the computation of the taxpayer's NOL carryforward.

Because the court determined the petitioner held land for investment purposes that he then donated to charity, the charitable deduction was the difference between the selling price of the land to the charity and the FMV. IRC §170(e) did not apply.

> **Note.** The court did not impose an accuracy-related penalty because the petitioner justifiably relied on the advice of his tax preparer who was well-versed in preparing such complex returns.

Taxpayer's Land Sale Gains Taxed As Ordinary Income

In *Boree v. Comm'r,*[195] the petitioner was a self-described real estate professional who received income from the sale of land. The petitioner reported the income as capital gain, but the Tax Court ruled that it was ordinary income because the petitioner held the property primarily for sale to customers in the ordinary course of the petitioner's real estate business. The court noted the issue of whether the petitioner was a developer (ordinary income treatment) or an investor (capital gain treatment) was fact dependent, and the facts supported developer status. The petitioner held his business out to customers as a real estate business and engaged in development and frequent sales of numerous tracts over an extended period. In prior years, the petitioner had reported the sales as ordinary income and had deducted the expenses associated with the tracts. On appeal, the appellate court affirmed the decision, but reversed the Tax Court's holding that the petitioner was subject to an IRC §6662 penalty.

> **Observation.** The preceding discussion appears to make the argument that Greg from **Example 13** may rightly be treated as both a dealer in real estate and an investor. The 25 lots Greg developed could fall within the category of real property trades or businesses because not only did he **intend** to develop land and sell lots, he actually **did** develop and place lots up for sale. *Conner v. Comm'r* (discussed earlier) may provide the best insight to address Greg's situation because the circumstances presented in *Conner* are not dissimilar to Greg's. Greg has property held for sale in the normal course of business (developed lots held for sale) as well as property held for investment (50 acres of undeveloped land) that could receive capital gain treatment upon sale.

195. *Boree v. Comm'r,* 837 F.3d 1093 (11th Cir. 2016), *aff'g in part and rev'g, in part,* TC Memo 2014-85.

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Practitioner Planning Tip

As explained in the preceding material, a thorough discussion regarding the facts and circumstances surrounding a client's intent is crucial in determining the proper tax treatment of income. Practitioners are cautioned not to "coach" a client into supplying answers that could result in the most favorable tax treatment. The actual facts and circumstances should be used, even if the outcome is not as favorable as desired.

MISCELLANEOUS

No Gain/Loss on Short Sale of Rental Property

In *Simonsen v. Comm'r,*[196] the petitioners, a married couple, bought their home with nonrecourse debt. They moved out five years later and converted their home to a rental property. Shortly thereafter, they completed a "short sale" in which they sold the property to a third party for an amount insufficient to cover the outstanding loan balance. The lender agreed to release its lien on the property to facilitate the sale and the petitioners gave all of the sale proceeds to the lender.

The petitioners reported a deductible loss on the sale of the rental property and did not report the canceled debt as income, believing the debt forgiveness and the short sale were two separate transactions. The IRS determined that the transaction was a single sale resulting in no canceled debt income, but that there was no deductible loss. The IRS also imposed an accuracy-related penalty.

The Tax Court agreed with the IRS position that the short sale and debt forgiveness were part of one transaction and that there was no income from the canceled debt. Moreover, the amount realized included the discharged nonrecourse debt. The court determined the amount realized exceeded the petitioners' loss basis in the property in accordance with Treas. Reg. §1.165-9(b)(2). However, the amount realized was less than the petitioners' gain basis in the property. Consequently, there was no gain or loss on the sale. The court did not uphold the accuracy-related penalty.

Mortgage Payments not Deductible as "Rents"

In *Christopher C.L. NG MD, Inc., APC v. Comm'r,*[197] the taxpayer was a C corporation that had a medical doctor as its sole shareholder and employee. The shareholder is a physician that contracted with a medical group to provide emergency medical services to a hospital. The corporate business address was the shareholder's personal residence in Los Angeles. The shareholder used the second story of the residence to access patient records remotely, complete notes on patients, and do continuing education training as well as certification activities for medical boards. No patients were treated at the residence, and the only other persons that have used the residence for business purposes were the shareholder's paid "assistant" and his medical malpractice defense attorneys.

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196. *Simonsen v. Comm'r,* 150 TC No. 8 (2018).

197. *Christopher C.L. NG MD, Inc., APC v. Comm'r,* TC Memo 2018-14 (Feb. 5, 2018).

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Upon advice of a tax return preparer, the shareholder deducted 100% of his mortgage payments as "rents" on the C corporation return. In addition, the shareholder, on his personal return, claimed an itemized deduction for the mortgage interest and did not list any income on Schedule E. The IRS disallowed the rent deduction on the corporate Form 1120 because it was, in reality, a mortgage payment made by the corporation for the shareholder's personal residence. The shareholder filed amended personal tax returns on which he included the rental payments. However, he filed the amended returns after April 15, 2016, more than three years after the close of the 2012 tax year, which was the tax year in issue.

The Tax Court agreed with the IRS and noted that, under §162(a), a C corporation may deduct payments made to lease home office space from an employee (or from its owner) as rent if they are ordinary and necessary business expenses directly connected with or pertaining to the corporation's trade or business. The lessor-employee must report the rent payments received as income on Schedule E with no offsetting home office deduction. However, for the deduction to be claimed, the Tax Court noted there must be a valid rental arrangement and the burden to establish the existence of the arrangement was on the corporation/lessee shareholder. The Tax Court determined that the valid lease arrangement was not established. There was no written rental agreement, and the shareholder did not report the rental income on his personal return.

The court noted the entity at issue was a C corporation, which did not invoke the rules of IRC §280A as would have been the case with a sole proprietorship or S corporation. The Tax Court determined the corporation owed approximately $150,000 of tax on the non-approved mortgage interest plus an accuracy-related penalty of $29,705.

No Deductions for Rental Property Expenses

In *Okonkwo v. Comm'r,*[198] the taxpayer was a cardiologist and his wife worked in his practice. They constructed a second house in Woodland Hills, California, in 1997 and tried to sell it for four years. They rented the house for four years to an unrelated tenant and then to their daughter at one-third of the rate charged to the unrelated tenant. They resumed sales efforts in 2010.

On their 2008 return, the petitioners indicated the house was rental property that incurred a net loss of $134,360, which they characterized as a passive loss on Form 8582. On the 2009 and 2010 returns, the petitioners again showed net losses on the property, but indicated they were in the construction business. They filed a 2008 amended return claiming a refund relating to expenses claimed on the house. The IRS disallowed the refund and assessed an accuracy-related penalty. The IRS determined the house was held for the production of income and the losses were passive losses under §469. The IRS also asserted the deductions attributable to the house were limited by §280A.

The court agreed with the IRS because a related party lived in the house and used it for personal purposes for more than the greater of 14 days per year or 10% of the number of days the house was rented at a fair rental price. The court rejected the petitioners' claim that they were real estate developers who needed to have their daughter live in the house to keep it occupied as required by their homeowner's policy, which would then make §280A inapplicable. Thus, the deductions attributable to the house were limited to the extent of rental income.

The court upheld the application of the accuracy-related penalty and did not need to determine whether the losses were passive. On appeal, the court affirmed, determining that the daughter provided only minimal services while she resided in the home, which did not make up for the difference between the fair market rent and the amount she paid.

> **Note.** For a summary of the taxpayers' lower court case, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Rulings and Cases. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

198. *Okonkwo v. Comm'r,* 705 Fed. Appx. 667 (9th Cir. 2017), *aff'g* TC Memo 2015-181.

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"Vacation Home" Rules Sink Deductions for Bed and Breakfast

In *Cooke v. Comm'r,*[199] the petitioner, an Alaska resident, created an LLC that purchased a home in Indiana the petitioner operated as a bed and breakfast run by on-site managers. The on-site managers were provided with an apartment on the premises to use as their personal residence. The bed and breakfast ceased operating in 2010, but deductions associated with the business continued into 2011.

The IRS disallowed associated losses under the "vacation home" rules of §280A(a), which disallows deductions associated with a dwelling unit that the taxpayer uses as a residence during the tax year. A dwelling unit is used as a "residence" if the taxpayer uses it for personal purposes for more than the greater of 14 days or 10% of the number of days during the tax year the unit is rented at a fair rental value. The petitioner's pass-through entity, the LLC, is considered to have made personal use of a dwelling unit on any day on which any beneficial owner would be considered to have made personal use of the unit. If the taxpayer is engaged in repairing and maintaining the property substantially full time on any day, that usage does not constitute personal use of the unit. The evidence showed that the petitioner stayed at the home 26 days in 2010 and 33 days in 2011, and the petitioner could not establish evidence to the contrary.

The petitioner's daily activity logs were created during the IRS examination of the matter and did not provide specific details about the activities he performed. The petitioner also employed a landscaping firm during the tax years in issue.

The court disallowed all of the losses associated with the home, a worse result than having them disallowed under the passive loss rules of §469, which would be deferred until the home is disposed of in a taxable transaction. The court also imposed a 20% accuracy-related penalty.

No Equitable Interest in Home Means No Mortgage Interest Deduction

In *Jackson v. Comm'r,*[200] for tax years 2011–2012, the petitioner lived with his girlfriend in a residence she purchased in 2005. She financed the purchase with a mortgage and was listed on the deed as the sole owner. She was also the only person responsible on the mortgage.

The petitioner claimed a mortgage interest deduction, and the IRS disallowed it. The petitioner claimed to have transferred $1,000 in cash to the girlfriend every month to make "interest only" mortgage payments on the residence. However, he could not substantiate the alleged transferred amounts. The girlfriend paid all of the homeowners' insurance premiums and property taxes on the residence. The petitioner did not show that he could make improvements to the property without her consent or that he could obtain legal title by paying off the mortgage.

The court agreed with the IRS and determined that, without her testimony, there was no way to establish the petitioner held an interest in the property similar to a community property interest under state (Nevada) law. In a separate decision, the court determined the petitioner was not entitled to a mortgage interest deduction on the same property for tax year 2013.

Observation. This case highlights the importance of written documentation and testimony.

199. *Cooke v. Comm'r,* TC Memo 2017-74 (May 1, 2017).

200. *Jackson v. Comm'r,* TC Summ. Op. 2016-33 (Jul. 5, 2016); *Jackson v. Comm'r,* TC Summ. Op. 2017-11 (Mar. 6, 2017).

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IRS Forecloses on Couple's Community Property to Pay Spouse's Tax Debt

In *U.S. v. Smith,*[201] a married couple resided in the state of Washington, a community property state, and the husband incurred liabilities for unpaid taxes in 1999–2004. Married taxpayers in a community property state who do not file joint returns must report half of the total community income they earn during the tax year, unless an exception contained in IRC §66 applies. However, the IRS can tax a spouse's entire income if the spouse acted as if they were solely entitled to the income and did not notify their spouse of the income before filing. In such a situation, innocent spouse relief may apply.

In a prior action, the court determined the IRS had valid tax liens on all of the couple's property and the IRS moved to foreclose its liens on the couple's community property home. However, the wife claimed the IRS could not satisfy her husband's tax debt with her share of the home because the state of Washington's community debt doctrine did not apply.

The court disagreed, noting all debt acquired during marriage is presumed to be community debt and the wife had not provided clear evidence to the contrary. The court rejected the wife's claim that she should have been sent a deficiency notice, finding that was a nonissue because the tax liability was only assessed against her husband. The court also held the wife was not entitled to innocent spouse relief because her husband did not act as if he was entitled to all of the income or that he failed to notify her of that income.

> **Observation.** Married couples residing in community property states should be aware that the IRS can foreclose on marital property even when the tax liability is tied to only one spouse.

201. *U.S. v. Smith,* No. 3:14-cv-05952-RJB, 2016 U.S. Dist. LEXIS 15249 (W.D. Wash. Feb. 8, 2016).

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