

# Chapter 25:

## Tax Factors Pertaining to Real Estate Practice

An \* in the left margin indicates a change in the statute, rule or text since the last publication of the manual.

### I. Introduction

This chapter presents a general overview of the rules for individual taxpayers that pertain to the acquisition, ownership and sale of residential real estate. Professional assistance is required to determine the tax consequences or reporting requirement that may pertain to a specific real estate transaction. One should permanently retain all original contracts, settlement statements and related banking records for such ownership for subsequent tax reporting.

The use of a property generally drives the tax consequence and reporting of its ownership. Property is commonly held for purposes such as personal use, business operations or investment purposes, and these purposes may change and intermingle during the life cycle of ownership. The method of tax accounting used by the taxpayer also determines deductibility and reporting rules. In “**cash basis**” accounting, benefits (income and expenses) are considered reportable or deductible when “constructively received” in cash or an equivalent form, or actually paid. The “**accrual basis**” generally applies to businesses with salable inventories. Under the accrual basis, one reports income when the right to receive it occurs. Expenses are likewise deductible when they are incurred, that is, when all events have occurred that fix the amount of the expense and create a tax liability for the individual. The purpose of accrual accounting is to better match reporting of income with the associated expenses of generating it. IRS accounting requirements are found in Publication 538.

Some resources for tax information are the U.S. **Master Tax Guide**, published annually by Commerce Clearing House, <http://www.cch.com> and various **IRS Publications and Forms** which may be viewed, downloaded or ordered on CD from the National Technical Information Service (NTIS) at the website: <http://www.irs.gov>. These documents and forms may be read at the Website, but the user will need Adobe Acrobat 6.0 or similar software to print most documents on a home computer. The discussion of tax rules in the following sections is based on material contained in these references in effect as of January 1, 2006. Tax law changes are found in IRS Publication 553.

### II. Ownership of a Personal Residence

Federal tax law provides extensive tax benefits for purchase and ownership of a home. These benefits deal with buying expenses, new provisions for financing purchases, qualified deductible residential interest, property taxes, non-business theft and casualty losses, moving expenses and business or rental use of a home. They are described in IRS Publications 17 (Your Federal Income Tax), 523 (Selling Your Home), 527 (Residential Rental Property), 530 (Tax Information for First-Time Homeowners), 547 (Casualties, Disasters and Thefts), 551 (Basis of Assets), 587 (Business Use of Your Home), 936 (Home Mortgage Interest Deduction) and Form 8396 (Mortgage Interest Credit), 590 (Individual Retirement Arrangements), and 225 (Farmer’s Tax Guide).

### **A. Buying Expenses**

A buyer may find certain settlement and closing costs deductible, capitalized (added to the cost or “basis” of the property) or of no tax benefit. The deductibles generally include real property taxes and discount points for the purchase or construction of a principal residence. Non-deductible items generally include other settlement costs such as appraisal fees, notary fees, VA funding fees, points not separately paid for by the borrower at closing for property improvements (these are generally deducted over the life of the loan), title insurance, survey costs, legal fees, loan origination fees and other similar costs. Non-deductible items are added to the basis of the property and will ultimately reduce the gain or increase the taxpayer’s loss in a subsequent sale. These gains or losses may be excluded at the time of next sale or deferred in certain circumstances until the final sale of a residence. See Publication 530 for more information.

### **B. IRA Withdrawal Used to Fund Purchase**

The “Age 59½ Rule” allows first-time homebuyers to use IRA distributions to fund up to \$10,000 of the cost of their new home without incurring the 10% early distribution penalty (Publication 590). A first-time homebuyer can be the individual, a spouse, child, grandchild, or parent of the individual or spouse. To qualify, a buyer must have had no present ownership interest in a principal residence during the two-year period ending on the date of acquisition of the new residence. Special rules apply to armed forces members or owners of property outside the U.S. The date of acquisition is the date a binding contract to purchase the property is executed, or the date when construction of the principal residence begins. IRA disbursements can be used to pay the costs of acquiring, constructing, or reconstructing a residence, and include any reasonable and common cost of settlement, financing or closing the transaction. However, any amount withdrawn must be used to pay qualified acquisition costs within 120 days of the date of withdrawal.

### **C. Qualified Residential Mortgage Interest**

This interest is deductible on itemized returns if the following requirements are met (Publications 530 and 936): The mortgage interest must be charged on a foreclosable note for debt secured by a recorded deed of trust (or perfected title under state law) on a personal residence or a qualified second home selected during the tax year by the owner. A “qualified residence” for this deduction is defined as a house, condominium, mobile home, houseboat, house trailer, or any other facility (excluding unimproved vacant land) that has sleeping quarters, a toilet, and cooking facilities. A qualified second home is one that is used by the owner at least 14 days or 10 percent of the total number of days that it is rented to others, whichever is greater. If a second home is not rented to others, it may be a qualified home regardless of whether a taxpayer uses it during the year or not. A taxpayer who rents out a second residence may deduct mortgage interest only if the property meets the test of a “qualified residence”. If a taxpayer does not satisfy these tests the residence is considered rental property, rather than a qualified second home, and may be subject to the passive activity rules. These are very complex areas of tax law and expert professional assistance is recommended. See Publication 925 (Passive activity and at-risk Rules) for more information.

A residence under construction can be treated as a qualified residence for up to 24 months, only if it actually becomes a qualified residence when ready for occupancy. The land

upon which the construction is undertaken does not become a qualified residence until construction actually begins.

Residential interest generally includes mortgage interest on home acquisition debt of up to \$1 million (\$500,000 for married filing separately) plus up to \$100,000 (\$50,000 for a married person filing separately) on a qualifying home equity loan. Certain items can be included as home mortgage interest. These items include late payment charge on mortgage payment, redeemable ground rents, interest on stock purchased in a cooperative housing residence, certain “points” or loan origination fees paid by a purchaser or by a seller for the purchaser and mortgage prepayment penalties. Acquisition indebtedness proceeds must generally be “traceable” to expenditures to acquire, construct or substantially improve a qualified residence. Acquisition indebtedness includes debt used to refinance earlier indebtedness (meeting the definition for acquisition indebtedness) to the extent of the original indebtedness. IRS Publication 936 provides a special 90-day rule exception to the literal application of the tracing rules for expenditures on a qualified residence. This exception provides that debt incurred within 90 days after the completion of the construction or improvements is treated as incurred to construct or improve the residence to the extent those expenditures occur not more than 24 months before project completion, and after completion, up to the time the debt is incurred. A purchaser claiming an interest deduction for private seller-carry financing must include the name of the seller, the seller’s address, and the seller’s TIN on the purchaser’s income tax return Schedule A. Failure to furnish this information is subject to a fine.

Note: “grandfathered debt” (pre-October 14, 1987 debt still of record on the property) is not subject to the \$1 million acquisition debt ceiling, but any pre-October 14, 1987 debt reduces the ceiling for any new post-October 13, 1987 debt used to improve or refinance the property. Pre-October 14, 1987 debt does not have to be “traceable” as indicated above, but must be still secured by the residence at all times thereafter. Debt used to refinance the “grand fathered debt” qualifies for this same treatment to the extent of pre-October 14, 1987 debt principal. Home equity loans are limited to the lesser of \$100,000 (\$50,000 for a married person filing separately) or the fair market value of the residence less accession indebtedness including pre-October 14, 1987 grandfathered indebtedness.

#### **D. Mortgage Interest Credit**

This credit may be available for first-time homebuyers whose income is generally below the median income in the area where they live. This credit is intended to help lower-income individuals afford home ownership. To be eligible for this credit the buyer must obtain a “mortgage income certificate” from a participating state or local agency before making any offer to buy a home or seek a loan. According to the State Housing Division (303) 866-4649 and Colorado Housing and Finance Authority (CHAFA) (303) 297-2432, this program is only active in Routt County. The future of the state or local programs for such housing is unknown. Any tax credit obtained is reported to the IRS on Form 8396. The borrower may have to recapture (repay) all or part of the benefit received from that program when the home is sold or otherwise disposed of. See Publication 523 for further federal information.

## **E. Property Taxes**

Real property tax includes local, state and foreign taxes levied on the value of real property. It does not include special assessments for local benefits or improvements such as sidewalks, streets, and water or sewer systems.

Property taxes are generally deductible by the person(s) on whom they are levied in the year they are accrued or paid. In the year of acquisition or sale, both the buyer and seller must apportion among themselves any real property taxes levied for applicable “real property tax year.” The date of sale and the statutory date the taxes become due govern how to determine the prorated amount each party may deduct, according to the number of days each party held ownership of the property. Computation of the prorated property tax amount is illustrated in Chapter 19 of this manual.

- \* In Colorado, the current year’s property taxes come due the following January 1. A buyer may deduct the prorated share of real property taxes for the year as they are paid on the date of closing. Cash basis buyers generally cannot take any property tax deduction for taxes placed in escrow through monthly payments until the escrow holder pays the tax. Lenders will report the deductible amount to the borrower annually for preparation of the return.

When a buyer pays the taxes after the date of sale, the seller is treated as if he or she paid the taxes on the date of sale and the seller will deduct that amount on Schedule A. Delinquent taxes due from the seller which were included in the contract price are not deductible. The buyer adds this amount to the cost (basis) of the property purchased.

Transfer taxes charged by some local tax authorities on the sale of a personal residence are not deductible. The person paying this tax may adjust the basis of the property by such amount.

## **F. Personal Property Taxes**

To qualify for this itemized deduction, the tax must meet three tests: (a) must be charged on personal property, (b) must be based only on the value of the property, and (c) the tax must be charged on a yearly basis, even if collected more or less than once a year.

## **G. Non-business Casualty and Theft Losses**

A casualty or theft loss results from the damage, destruction, or loss of property from an event that is direct, identifiable, sudden, unexpected or unusual (IRS Publication 547). The amount of the loss is generally the lesser of (1) the loss in fair market value before and after the event, and (2) the adjusted basis of the property before and after the event. A business casualty loss is fully deductible, while a personal loss is only a loss over \$100, and is further limited to the net loss (above the floor) in excess of 10% of the taxpayer’s adjusted gross income. The 10% limitation also applies to the adjusted gross income of any estate and trust claiming a personal casualty or theft loss. Special rules are used for federally designated disaster areas. IRS Publication 584 (Non-business Disaster, Casualty, and Theft Loss Workbook) should be used to document and compute these losses.

Losses from progressive deterioration due to neglect or steadily operating environmental conditions, disease, drought, insects, accidental breakage, pets and arson are not deductible. Landlords and tenants may claim theft and casualty losses on rental property. Special rules apply to situations where both casualty gains and losses occur. Incidental expenses may not

be deducted and the loss reported may not exceed the adjusted basis in the property destroyed or stolen. The taxpayer must itemize to deduct this loss.

### **H. Moving Expenses**

Taxpayers may deduct (subject to certain limits) unreimbursed moving expenses related to taking a new job or changing jobs, including self-employment, if certain distance and subsequent time of employment tests are met. A taxpayer may also deduct these expenses if the taxpayer expects to meet these tests in the following consecutive year(s). Special rules apply to members of the Armed Forces; they are not required to meet the distance and time tests for a permanent change of duty station. See IRS Publications 17 and 517, for further information.

### **I. Business Use of Home (Home Offices)**

The Internal Revenue Service has released Publication 4035, Home-Based Business Tax Avoidance Schemes. It describes schemes that claim to offer tax relief but actually result in illegal tax avoidance.

The definition of a “principal place of business” is: (1) a place exclusively and regularly used for the administrative and management activities of a trade or business, and (2) no other fixed location where substantial administrative or management activities of the trade or business are conducted. Some examples of these activities are: billing customers and clients, keeping accounting records and related books of activity, ordering supplies, setting up appointments, developing professional expertise and maintaining related skills, and preparing reports and information necessary to customers and clients.

Other tests necessary for the deduction have not changed; these are: exclusive and regular use of the office for your regular trade or business and the business part of your home must be one of the following: a principal residence, a place where you meet or deal with patients, clients, or customers in the normal course of business, or a separate structure not attached to your home used in connection with the trade or business. In addition, employees must meet the foregoing tests plus: the business use must be for the convenience of the employer and you do not rent all or part of your home to your employer and use the rented part to perform services as an employee. Exceptions to exclusive use are for the storage of inventory or product samples and the use of part of your home as a day-care facility for the elderly, children or persons who are physically or mentally unable to care for themselves. Otherwise, commingled personal and business use of the area is not permitted.

## **III. Sale of a Personal Residence**

When a taxpayer sells a principal residence, any loss is not deductible unless part of the residence was used in the taxpayer’s business. IRS Publication 523 describes the reporting requirements for this type of transaction; Publication 544 describes the sale of rental property, second homes or vacation property. A trade of homes is treated as a sale and purchase.

Form 2119 is used to report a one-time exclusion of gain on the sale of the residence. Any taxable gain is reported on Schedule D as a capital gain. Depending on the date of the sale, the gain may either be “excluded” or “postponed”. A loss on the sale of the main home (excluding business use) is personal and isn’t deductible on the return or used as an

adjustment to the basis in a new home. Basis must be adjusted for any depreciation taken for any part of the home used in a trade or business. Points not deducted may be deductible in the year of sale. See “points” in Publication 936, Part I.

The seller may be able to “exclude” up to \$250,000 (\$500,000 if married filing jointly) of any realized gain on the sale or exchange of a personal residence. This applies to stock held by a tenant/shareholder in a co-operative housing unit used by the seller as a main home. Gain or loss is the selling price of the home minus expenses of the sale and the adjusted basis in the home. Adjusted basis is generally the original cost plus certain buying costs, improvements, and postponed gain under the former law when the residence was acquired. Any depreciation taken further decreases the basis. Any gain properly excluded is not reported on the return.

Current tax rules allow reuse of the exclusion amount for any subsequent transaction meeting all of the following tests where a taxpayer: (1) has “ownership of the property for two of the five years before the current sale or exchange, (2) “used” by occupying it for periods totaling two years within the last five years, ending on the date of the sale or exchange, (3) meets the “one-sale-in-two-years” criteria, where the \$250,000/500,000 exclusion was not used for the prior sale of any residence for the two-year period ending on the date of the current sale or exchange. If a seller does not satisfy these tests, he/she may qualify for a reduced maximum exclusion if the primary reason for the sales is a change in employment, health or unforeseen circumstances. See Publication 523 for rules applicable to reduced exclusions, foreclosures, other special situations and instructions for worksheets to compute the gain or loss. Divorce property settlement rules are described in Publication 504 and Publication 544 deals with condemned property.

Under previous tax rules if the residence now being sold was acquired in a rollover transaction, where the gains were postponed, the periods of ownership and use of the prior residence(s) are generally considered continuous in the “use” and “ownership” tests for exclusion under the new rules. The postponed gains adjust the basis of intermediate properties in the ownership “chain,” and the resulting gain from the preceding transaction is used to determine the amount excluded under the new rules.

Additional rules apply to the replacement period for homes outside the U.S. and for members of the armed services.

If the property is temporarily rented during a period when it is offered for sale, the property is still treated as the “sale of a personal residence,” and retains use and ownership qualifications for the new gain exclusion.

An owner (not engaged in rentals for profit) who rents a property pending its sale may offset the rental income with allowable interest and property tax deductions. To the extent the income still exceeds allowable interest and taxes, the owner may use maintenance expense and insurance as additional offsets to the extent such use does not create a loss. Non-profit rental activities are reported as “other income” on the return per Publication 527. The offsetting expense (in excess of 2% of AGI limit in Schedule A) is reported as miscellaneous itemized deductions, and thus may ultimately result in part of the offsetting income being taxed as ordinary income on the return.

A taxpayer’s dwelling is considered a principal residence if used for personal purposes by the taxpayer or member of his/her family. But renting at fair market value to a relative who

uses it as their principal residence would preclude treating the dwelling as property used for personal purposes under the “use” test.

### **A. Installment Sales**

A homeowner who carries back part of the sales price in the form of a note may defer payment of gains until received as installment payments. This allows a seller to spread payment of taxes over the life of the loan. The seller must charge a fair interest rate and some restrictions apply to dealers and sellers of time-shares and residential lots. Additional information on this type of sale is contained in the chapters on contracts, financing and deeds. The broker should be familiar with the risks to both buyers and sellers, and advise the parties to seek legal counsel in such transactions.

### **B. Foreclosure**

Upon default, abandonment or conveyance in lieu of foreclosure, a gain in the form of discharge of debt may result to the mortgagor, or such gain may be used to reduce the basis of certain depreciable business property. In a foreclosure sale, the mortgagor generally recognizes a gain (or loss) in that the amount received exceeds (or is less than) the adjusted basis of the property sold. Transfers of property and abandonments are considered “sales” for tax purposes. The discharge of debt through cancellation in bankruptcy (Chapter 12) is generally not taxable income to the discharged debtor.

### **C. Colorado Withholding Tax on Certain Transfers of Real Estate**

Closing entities are generally required to withhold the lesser of (a) 2% of sale price or (b) the entire net proceeds, as a tax on the sale of Colorado property when the seller has moved or will move out of state. The law is at the end of this chapter, and settlement procedures are shown in Chapter 19.

## **IV. Property Used in a Trade or Business**

This section describes general rules for certain residential rental activities found in IRS Publication 527 (Residential Rental Property—Including Vacation Homes) and other related references. Readers should review Publication 553 or other tax periodicals for additional information on specific transactions.

### **A. Rental Property Operations**

With some exceptions, property owners are required to report all rental amounts received in cash or services at fair market value on their return. Rental income includes any payment received for the use or occupation of the property, and includes advance (first and last month) rents, no matter when received, or what accounting method is used. Refundable security deposits returned to the occupant are not income, except to the extent retained by the owner in excess of related expense. The rental income and the related expenses for a residential property rented for less than 15 days is not currently reportable on the tax return. The tax rules described in this section don’t apply to temporary rentals of properties that are for sale.

When property is rented it is generally treated as two pieces of property—the part used as a home and the part used for rental. A taxpayer must divide expenses between the personal and rental use (except for minimal rental use—less than 15 days).

A dwelling unit or home includes a house, apartment, condominium, boat, recreational vehicle or similar property which has basic living accommodations such as sleeping space, toilet, and cooking facilities, but excludes part of a home used exclusively as a hotel, motel, inn, or similar establishment. Exclusive use means available for and solely used by paying customers other than the owner during the entire year.

Tax treatment of rental income and expenses for a dwelling unit or home depends on how many days the home/dwelling unit was rented. The unit is considered a home if used for personal purposes more than the greater of: 14 days, or 10% of the total days it was rented to others at fair market value.

If the property is not used as a home, then all income and all expenses are generally reported as supplemental ordinary income in Schedule E or on Schedule C when significant services are provided to guests and/or tenants. Deductible expenses may exceed gross rental income, but a taxpayer must generally offset any “passive” rental loss from other “passive” income to deduct the loss. Any excess deductible loss is carried forward to the next tax year. See Publication 925 (Passive Activity and At-Risk Rules) for more information.

There is an exception for a “qualified person”, where losses from real estate activities in which the person materially participates is not limited by the passive activity rules. The person may be able to deduct up to \$25,000 of loss (\$12,500 married filing separately) from ordinary income. This deduction is phased out as adjusted gross income exceeds \$100,000 and is eliminated at \$150,000. A qualified person must own 10% of the value of all interests in the activity at all times and must “actively” participate in the operation of the property, both in the year of loss and in the year when any claim against income or certain credits is sought under the loss carryover provisions. IRS Publication 925 disallows this loss to owners of short-term and time-share rental activity, who fall into the classification of “passive” rental activity, due to a lack of material participation in operations, or who have averaged rentals of seven days or less. Stringent tests define “material participation” and professional advice is essential before taking this deduction.

If a dwelling unit was used as a home and was rented for less than 15 days, no income or expense need be reported. If rented for 15 days or more, the income less all expenses including depreciation is reported on Schedules E or C as described above. If expenses are greater than income, the excess is carried over to the following year to offset future income (see Publication 527 for a table to compute that amount). The carryover loss amount will also be subject to this limit and treatment in the following year.

## **B. Depreciation**

Real property (excluding the land and landscaping costs) and personal property used in a trade or business with a useful life of more than one year may be eligible for treatment as a tax deduction called depreciation. Depreciation generally allows the taxpayer to recover the purchase cost of assets invested in a trade or business over time. Accounting and record keeping for these items and costs is very important. The total amount of depreciation can't exceed the basis of the depreciated property. The main factors in determining this amount are: the applicable tax law, the basis in the property, the recovery period, and the depreciation method used. See Publication 946 (How to Depreciate Property).

A taxpayer must claim the correct amount of depreciation each year. This amount will be used to reduce basis of the property, even if it was incorrectly reported or not taken on the



return. The taxpayer must file an amended return to recover any unclaimed depreciation within three years from the filing date of the original return, or within two years from the date the tax was paid, whichever is later.

There currently are three types of rental property depreciation systems. They are: Modified Accelerated Cost Recovery System (MACRS) for tangible property placed in service after 1986, Accelerated Cost Recovery System (ACRS) for property placed in service after 1980 but before 1987, and the useful lives of the property using either straight line or another accelerated computational method if placed in service before 1981. The last two systems are described in Publication 534.

MACRS determines depreciation in one of two methods: Most rental property (buildings, structures, and structural components) is subject to the “General Depreciation System” (GDS). The taxpayer may elect to use the “Alternative Depreciation System” (ADS). The main difference in these methods is that the cost recovery time period under GDS may be shorter than ADS. The taxpayer should use IRS Publication 946 to determine the applicable recovery period and class of the property to be depreciated under these methods.

Taxpayers may elect to “expense” and deduct from taxable income, rather than to “capitalize” and depreciate over the useful life, certain qualifying Section 1245 assets, in the year of acquisition. Items expensed in this manner are known as “Section 179 Property.” This election is made on Form 4562. The maximum deductible amount is reduced dollar for dollar for the cost of property placed in service in the amount over \$200,000. The deduction taken can’t exceed the total taxable income generated from active conduct of any trade or business during the tax year. Any disallowed amount is carried forward for an indefinite number of years, subject to the ceiling for that particular tax year.

Using an accelerated depreciation method may require filing Form 6251 to compute Alternative Minimum Tax. Accelerated depreciation includes MACRS, ACRS and any other system resulting in a deduction greater than that computed by the Straight Line Depreciation Method. Straight line depreciation is the number “1” divided by the number of years of useful life, adjusted by any applicable tax “convention” for the specific class of property being depreciated, times the asset cost. The more common conventions are half-year or mid-quarter. An asset would be depreciated for half-year in the year of acquisition or disposal, no matter when in the year it was actually acquired.

When personal use property is converted to rental use, the taxpayer must determine the basis of the property for purposes of depreciation. This is generally the lesser of the fair market value or the adjusted basis on the date it is placed into rental use. The determination of basis is described in IRS Publication 551 (Basis of Assets).

### **C. Certain Business Gains and Losses**

In addition to taxable business expense deductions (IRS Publication 535 Business Expenses) certain types of business property also produce special tax benefits through more favorable tax rates or deductions from ordinary income. These assets commonly are designated as Section 1231, 1245 and 1250 assets used in a taxpayer’s trade or business and are treated under the rules for “capital gains or losses”. Tax rules for these business items are found in IRS Publication 544 (Sales and other Dispositions of Assets).

“Capital assets” include most everything owned and used for personal or investment purposes. Some examples are: stocks, bonds, personal residence, household furnishings, a

personal automobile, jewelry, art collections, and similar items. Taxable gains or losses from the sale or exchange of capital assets are either classified as ordinary income or loss or as capital gain or loss. For individuals, net capital gain is taxed at a lower rate than ordinary income, and any capital losses are generally limited. A sale or exchange of capital assets between related persons is generally taxed as ordinary income, and any loss is not deductible, except when corporate property is distributed in a complete liquidation.

In contrast, business real estate and depreciable business property is excluded from the definition of capital assets. Non-capital assets are defined as property held for resale to others (inventory), business or trade accounts and notes receivable, depreciable property used in a trade or business, real property (including certain Section 179 intangibles) used in a trade or business, copyrights, literary, musical, or artistic compositions and certain acquisitions of publications from a governmental agency. However, if non-capital assets qualify as Section 1231, 1245 or 1250 property, gains or losses from these transactions may receive “capital gains or loss” treatment.

In general, the sale or exchange of depreciable business property is treated under the rules for Section 1231 property. Other depreciable property under Sections 1245 and 1250 requires recapture of the depreciation allowed or allowable as ordinary income, and any gain in excess of that amount is treated as a Section 1231 capital gain. Section 1250 property requires recapture of any “additional depreciation” (in excess of straight line or other specific methods) as ordinary income.

Section 1231 assets are depreciable real and personal property held for more than one year and used in a trade or business. Some examples are: rental homes, rental dwelling units, business machinery, equipment, leaseholds, livestock, crops and timber, and any of these items which have been involuntarily converted. Their tax treatment, as ordinary or capital items, depends on whether there is a net 1231 gain or loss from all 1231 transactions. A net 1231 loss is an ordinary loss, and if a net 1231 gain, it is ordinary income up to the amount of any non-recaptured 1231 losses not offset against prior 1231 gains in the last five years. The remainder is long-term capital gain.

Section 1245 assets are tangible and intangible personal assets that have been subject to depreciation. Some examples are tangible personal property, such as furniture, bulk storage units, livestock, office equipment, (except for buildings and their structural components), used as integral part of the business production process. The amount of gain treated as ordinary income from the sale, exchange or involuntary conversion of 1245 property (including a sale and leaseback) is the lesser of: the depreciation or amortization allowed or allowable on the property, or the gain realized on the disposition (amount realized less adjusted basis). Certain limits apply to like-kind exchanges.

Section 1250 property is any real property that is depreciable, but is not subject to recapture under Section 1245, that has never been used as Section 1245 property. Some examples are intangible property, such as leases of land, buildings and major structural components. The amount of ordinary income is computed according IRS instructions in Publication 544, and any remaining gain follows the treatment for Section 1231 gain.

If farm land held for nine years or less is disposed of, a percentage of the total post 1969 deductions for soil and water conservation expenditures will be recaptured as ordinary income depending on how many years the property was held and if other exemptions apply.

All of the gains or losses from Section 1231, 1245, 1250 property are reported on Form 4797. All Section 1231 gains or losses are reported in Part 1 of this form and any net gain from these transactions is carried to Schedule D as a long-term capital gain. Any net 1231 loss is carried to Part II of this form as an ordinary loss. Part IE handles the 1245 and 1250 items. Form 8824 is used for reporting like-kind exchanges of depreciable property.

The maximum capital gain rates on the net capital gain depends on the tax year and in what type of property the gain originates. "Net capital gain" is the excess of net long-term capital gain over net short-term capital loss for the year and is determined for individual taxpayers by use of Schedule D.

#### **D. Tax Credits applicable to business property**

These include the general business credit, disabled access credit, low-income housing credit, and rehabilitation credit.

#### **E. General Business Credit (combines credits and some described below)**

The investment credit (including the rehabilitation, energy and reforestation credits), empowerment zone employment credit, welfare-to-work credit, Indian employment credit, employer social security credit, alcohol fuels credit, orphan drug credit, enhanced oil recovery credit, renewable electricity production credit, disabled access credit, and low-income housing credit are all combined into the General Business Credit (GBC). Taxpayers may qualify to deduct part or all of this and other specific unused credits listed above at the end of any carry forward period.

The GBC is claimed for multiple credits on Form 3800. This form is not used if the taxpayer claims only one credit. Instead, where there are no carry backs or carryovers of the amounts claimed, use the specific tax form for the credit claimed.

The GBC is limited to the taxpayer's net income tax over: the greater of the taxpayer's "tentative minimum tax," or 25% of the taxpayer's net regular tax liability in excess of \$25,000.

The Taxpayer Relief Act of 1997 changed the time period for carry back or carry forward of unused general business credits. For credits earned in years beginning after 1997, the carry back period is reduced to one year, and the carry forward period is 20 years. For credits earned on or before December 31, 1997, the unused credits are carried back three years and forward fifteen. Certain components of the GBC may be subject to recapture if a property is disposed of within five years after being placed in service, or if the property is owned by a "pass-through" entity, and, when the credit was taken in a year that was subject to at-risk rules or to non-recourse financing limitations. Any recapture increases the property basis.

#### **F. Disabled Access Credit**

This component of the general business credit discussed above is subject to the same general limitations and carry back or forward provisions. It applies to expenditures made after November 5, 1990 to comply with the Americans with Disabilities Act to remove architectural, communication, transportation, or physical barriers to access or use of facilities by disabled persons. Deductions must meet standards set by the Architectural and Transportation Barriers Compliance Board as found in IRS regulations. The credit is available for qualifying small businesses with annual gross receipts of less than \$1 million, or

not more than 30 full-time employees. Neither a deduction nor increase in basis is allowed for this credit.

### **G. Rehabilitation Credit**

This credit is available for certain rehabilitations of qualified buildings first placed in service before 1936 and certified historic structures placed in service anytime. Qualified expenditures mean any amount charged to capital equipment in the reconstruction or rehabilitation of a nonresidential real property, a residential rental property, or real property with a class life of more than 12.5 years. Architectural and engineering fees, site survey fees, legal expenses, insurance premiums, development fees, cleanup, fire damage repair, and other related construction costs qualify if they are capitalized. The credit requires a basis reduction in an equal amount and a corresponding reduction in the basis of a partner's interest in a partnership or S corporation. Tax-exempt use of property doesn't qualify for this credit.

### **H. Low Income Housing Credit**

This is available for statutory low-income residential housing. It is claimed annually over a 10-year period on Form 8586. The credit percentages are set so that the 10-year amounts will equal a present value of 70% of the basis of a comparable new building that is not federally subsidized and 30% of an existing building or federally subsidized new building. A higher credit is allowed for certain high-cost areas. Rehabilitation expenditures also qualify if they exceed \$3,000 per unit.

A building generally qualifies if either 20% of the units are both rent-restricted and occupied by individuals with incomes of 50% or less of area median income, or if at least 40% of the units are both rent-restricted and occupied by individuals with income of 60% or less of the area median income. Mixed income multifamily property may qualify despite one resident's high income, if the next low-income unit is rented to an individual on a rent-restricted basis. These tests must be satisfied over a 15-year commitment period, and the penalty for noncompliance is recapture of the credit taken.

The IRS issued proposed regulations (Reg-114664-97) on January 7, 1999 requiring state and local housing agencies and owners to monitor compliance with the rules. Monitoring activity requires annual reports to the IRS, inspections of the projects once every three years, and a review of local government building code violations. Owners must certify annually that a project is suitable for occupancy, submit reports of code violations, and a CPA's opinion on the financial determination and certifications owners submit to the building inspection agency. The opinion includes the basis for the tax credit claimed. Please refer to IRC section 42 for further information.

## **V. Federal Estate and Gift Taxation**

### **A. Real Property**

The estate tax is imposed on all testamentary transfers regardless of probate. A special estate tax lien attaches to all property in the decedent's gross estate upon death, whether or not it is assessed and filed by the taxing authority. Foreclosure against purchasers of such property without knowledge of this attachment has been upheld in court. An executor for the

estate may elect to apply a special lien against specific property of sufficient value to pay all tax and interest due from the decedent.

- \* For 2006-2008, a Federal estate tax return (Form 706) is not required unless the deceased's estate amounts to \$2,000,000, increasing to \$3,500,000 in the year 2009. Under current legislation, the estate tax is repealed in 2010, but is completely reinstated in 2011 for estates valued at \$1,000,000 or more. In general, a return of the estate or trust must be filed by the fiduciary on Form 1041 when: the trust had gross income of \$600 or more for the tax year, any beneficiary is a non-resident alien, or the bankruptcy estate has gross income equal to the sum of unified credit exemption plus the standard deduction for married persons filing separately. The filing amount is known as the "unified credit" because it is deducted from any tax due on the decedent's estate in excess of that amount. See Publication 950 and 553 for further information.

Determination of the tax depends upon the value of the decedent's "gross estate," either at the date of death or by election at an alternative valuation date if elected six months later. Property held by the deceased, property transferred within three years before death, property transferred with a retained power of alteration, amendment or revocation is included. Certain deductions are subtracted from the gross estate, and credits may reduce taxes due.

- \* Principal deductions are for funeral and estate administration, claims against the estate, mortgages, marital property settlements, charitable contributions, losses, and bequests to a surviving spouse. The unified credit is deductible from any tax remaining. The credit changes each year. In addition credit may be taken for state death taxes, federal gift taxes, taxes paid on prior transfers, and foreign death taxes. The executor may elect to deduct the adjusted value of a qualified family-owned business interest up to a given amount from the gross estate, per instructions for Schedule T, Form 706.

## **B. Federal Gift Taxes**

- \* A living donor's gift is subject to gift tax, although a taxpayer may transfer up to \$12,000 each year (\$24,000 if the taxpayer's spouse makes a similar gift to the same person) without being subject to any tax or reporting requirement. The following are not generally taxable gifts: the first \$12,000 a donor or donor's spouse give to another during the year, tuition and medical expenses paid for someone else, gifts to a spouse, gifts to a political organization for its use, and charitable gifts. See Publication 709 for further information.

# **VI. Tax Treatment of Various Legal Entities**

## **A. Corporations**

A corporation is taxed as a separate legal entity on reported income. Dividends paid are also taxable to the individual receiving them. Associations, joint stock companies and insurance companies are taxed as corporations. Subchapter S corporations are not taxed on income, but serve as conduits for passing income, losses, and deductions to their stockholders.

## **B. Partnerships**

A partnership is not a taxable entity. All income, loss, credits and deductions pass through to the individual partners who share these items according to agreed upon amounts in

the partnership agreement. A partnership must file an informational tax return showing distributions to all partners.

### **C. S Corporations**

The small, closely held corporation may elect to be taxed as if it is a partnership. The requirements for election are to have 75 or less consenting shareholders, file a timely election, and issue only one class of stock. The election can be revoked by certain actions of the shareholders.

### **D. Limited Liability Companies (LLC)**

An LLC features many of the personal protections of a corporation, while preserving tax benefits of partnership and without the S Corporation's restrictions on eligible members.

### **E. Trusts**

A trust takes title to property on behalf of someone else. Trusts are subject to taxation and are allowed deductions for income distributed to the beneficiaries, who must report the distribution. Real estate investment trusts are subject to strict tax requirements concerning forms of organization, sources of income, and allowable assets.

### **F. Homeowner Associations**

If qualified, a homeowner association is taxed at 30% of its taxable income. "Exempt function income" derived from assessments on owner-members is generally not taxed. Taxable income includes amounts received as interest on sinking funds, amounts received for services provided to private property not owned by the association and amounts received from members for special services provided. An association must annually elect to exclude exempt function income.

### **G. Real Estate Mortgage Investment Conduit (REMIC)**

A REMIC is an entity formed to hold a fixed pool of mortgages. Tax provisions follow the class of ownership the taxpayer has in the REMIC. "Regular interest holders" are treated as debt holders of the REMIC. "Residual interest owners" are taxed on the prorated share of the REMIC net income, whether or not it is distributed. Both are taxed as ordinary income.

### **H. Tax Shelters**

These are generally classified into two groups: "Projected Income Investments" and "Abusive Tax Shelters." An investor should seek tax and legal counsel to determine how IRS classifies a shelter before making an investment.

A projected income investment is one not expected to substantially reduce the cumulative tax liability of any investor during the first five years the investment is offered for sale. Tax shelters previously qualified as a projected income investment may lose such status. Such loss requires registration with the IRS, and record keeping of sales between subsequent investors. Severe penalties may apply to any failure to keep records.

**Internal Revenue Bulletins** discuss abusive tax shelters. Such rulings bind the agency in enforcement of tax matters. The disallowance of tax deductions in such shelters may be accompanied by other severe tax penalties.

## VII. Employed Real Estate Licensees

Commission Rule E-29 and the related commission position statement CP-18, *Payments to a Wholly Owned Employee Corporation*, in chapter 3 recognize independent contractor agreements with the employing broker. The payment of earned commissions by the employing broker to a wholly-owned employee corporation is not considered payment to an unlicensed entity, pursuant to C.R.S. 12-61-113(1) or 12-61-117.

This recognition does not relieve the employing broker of the statutory responsibility to train and supervise licensed associates pursuant to Rules E-29 through E-32. Wholly owned corporations for this purpose are not licensed with the Commission and may never transact licensed business or hold money belonging to others in its own name.

## VIII. Withholding of State Income Tax on Proceeds from Transfers by Nonresidents of Real Property Located in Colorado

### *Colorado Revised Statutes § 39-22-604.5. Withholding tax – transfers of Colorado real property – nonresident transferors.*

- (1) Except as otherwise provided in this section, in the case of any conveyance of a Colorado real property interest, the title insurance company or its authorized agent or any attorney, bank, savings and loan association, savings bank, corporation, partnership, association, joint stock company, trust, or unincorporated organization or any combination thereof, acting separately or in concert, that provides closing and settlement services as defined herein shall be required to withhold an amount equal to **two percent of the sales price of the Colorado real property interest conveyed or the net proceeds resulting from such conveyance, whichever is less**, when:
  - (a) The transferor is a person and either the return required to be filed with the secretary of the treasury pursuant to section 6045 (e) of the internal revenue code indicates or the authorization for the disbursement of the funds resulting from such transaction instructs that such funds be disbursed to a transferor with a last-known street address outside the boundaries of this state at the time of the transfer of the title to such Colorado real property interest or to the escrow agent of such transferor; or
  - (b)
    - (I) The transferor is a corporation which immediately after the transfer of the title to the Colorado real estate interest has no permanent place of business in Colorado.
    - (II) For purposes of this section, a corporation has no permanent place of business in Colorado if all of the following apply:
      - (A) Such corporation is a foreign corporation;
      - (B) Such corporation does not qualify pursuant to law to transact business in Colorado; and
      - (C) Such corporation does not maintain and staff a permanent office in Colorado.
- (2) No title insurance company or its authorized agent or any attorney, bank, savings and loan association, savings bank, corporation, partnership, association, joint stock company, trust, or unincorporated organization or any combination thereof, acting separately or in concert, that provides closing and settlement services as defined herein shall be required to withhold any amount pursuant to this section:
  - (a) If the sales price of the Colorado real property conveyed does not exceed one hundred thousand dollars;

- (b) When the transferee is a bank or corporate beneficiary under a mortgage or beneficiary under a deed of trust and the Colorado real property interest is acquired in judicial or non-judicial foreclosure or by deed in lieu of foreclosure;
- (c) If the title insurance company or its authorized agent or any attorney, bank, savings and loan association, savings bank, corporation, partnership, association, joint stock company, trust, or unincorporated organization or any combination thereof, acting separately or in concert, that provides closing and settlement services as defined herein in good faith relies upon a written affirmation executed by the transferor, certifying under penalty of perjury one of the following:
  - (I) That the transferor, if a person, is a resident of Colorado;
  - (II) That the transferor, if a corporation, has a permanent place of business in Colorado;
  - (III) That the Colorado real property being conveyed is the principal residence of the transferor within the meaning of section 1034 of the internal revenue code; or
  - (IV) That the transferor will not owe tax reasonably estimated to be due pursuant to this article from the inclusion of the actual gain required to be recognized on the transaction in the gross income of the transferor.
- (3) Any title insurance company or its authorized agent which is required to withhold any amount pursuant to this section and fails to do so shall be liable for the greater of the following amounts for such failure to withhold:
  - (a) Five hundred dollars;
  - (b) Ten percent of the amount required to be withheld pursuant to this section, not to exceed two thousand five hundred dollars.
- (4)
  - (a) Amounts withheld and payments made in accordance with this section shall be reported and remitted to the department of revenue in such form and at such time as specified by rule and regulation of the executive director. Written affirmations executed pursuant to paragraph (c) of subsection (2) of this section shall be submitted to the department of revenue pursuant to procedures specified by rule and regulation of the executive director.
  - (b) All of the other provisions of this article shall apply to and be effective as to the provisions of this section to the extent to which they are not inconsistent with this section, and all of the remedies available to the department of revenue for the administration, assessment, enforcement, and collection of tax under other sections of this article and article 21 of this title shall be available to the department of revenue and shall apply to the amounts required to be deducted and withheld pursuant to the provisions of this section, and all of the penalties, both civil and criminal, shall apply to this section.
- (5) Whenever a title insurance company or its authorized agent provides escrow services as directed by the parties in compliance with the withholding requirements of this section, such title insurance company or its authorized agent shall charge the parties pursuant to the rates in effect at the time and filed with the division of insurance of the department of regulatory agencies as required by law.
- (6) For purposes of this section, unless the context otherwise requires:
  - (a) “Authorized agent” means a title insurance agent, as defined in section 10-11-102 (9), C.R.S., who is responsible for closing and settlement services in the transaction.
  - (b) “Closing and settlement services” means closing and settlement services as defined in section 10-11-102 (3.5), C.R.S., and section 38-35-125, C.R.S.
  - (c) “Colorado real property interest” means an interest in real property located in Colorado and defined in section 897 (c) (1) (A) (i) of the internal revenue code.
  - (d) “Escrow agent” means an agent for the purpose of receiving and transferring funds to a principal.



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- (e) “Person” means any individual, estate, or trust who may be subject to taxation pursuant to part 1 of this article.
- (f) “Sales price” means the sum of all of the following:
  - (I) The cash paid or to be paid, but shall not include stated or unstated interest or original issue discount as determined pursuant to sections 1271 to 1275 of the internal revenue code;
  - (II) The fair market value of other property transferred or to be transferred;
  - (III) The outstanding amount of any liability assumed by the transferee to which the Colorado real property interest is subject immediately before and after the transfer.
- (g) “Title insurance company” means the title insurance company, as defined in section 10-11-102 (10), C.R.S., responsible for closing and settlement services in the transaction.

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Ed. Note: See Chapter 11, Conservation Easements, for tax factors pertaining to Conservation Easement Holders.
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