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FEDERAL TAX CONSEQUENCES OF
ORDINARY TRANSACTIONS IN REAL
ESTATE

ROBERT E. MELDMAN* and NELSON S. WEINE**

I. INTRODUCTION†

The final consequences of a transaction in real estate, no matter how common or extraordinary, can differ substantially as a result of its tax effects. Some of the greatest tax catastrophes often occur in the day to day transactions of buying, selling and renting real estate. Thus, for purposes of guiding one's client to the best results, it behooves the practicing attorney to become as familiar as possible with the tax laws which can affect the outcome of a transaction in real estate.

II. HOW TITLE SHOULD BE TAKEN IN ACQUISITION OF REAL
ESTATE

One of the most important problems facing a taxpayer who plans to acquire real property is the form of ownership in which he should take title. The taxpayer may find that the tax consequences of the various forms of ownership will have an important bearing on his decision. Therefore, an analysis of the forms of ownership and their tax consequences must be considered.

A. Individual Ownership

If an individual holds title to trade or business property or to property held for the production of income, he must report the gross income from the property on his federal income tax return for the year in which the income is received or accrued. Correspondingly, he is entitled to deduct all of the expenses with respect to the property, including an allowance for depre-
ciation, in the year paid or incurred. As a result, the net income from the property is taxed to the owner at ordinary income tax rates even though he may have reinvested all the profits through improvements or payments on a mortgage. The only "shelter" available to the individual owner from the property is the allowance for depreciation.

B. Corporate Ownership

If a corporation which the taxpayer controls takes title to the property, the taxpayer has additional factors to consider. The particular facts and circumstances relating to each individual taxpayer will be determinative of which factors are favorable and which are unfavorable.

There are only two ways to transfer corporate funds from an operating corporation to its shareholders. One way is to pay the shareholder money in the form of a salary in exchange for services rendered to the corporation by the shareholder in the capacity of an employee. However, a salary payment may only be deducted from the corporation's gross income for tax purposes if the salary paid is reasonable and purely for services. If the shareholder of the corporation did little or no work for which he was paid a salary, it would be difficult to justify the salary as reasonable and purely for services. Accordingly, an individual would have difficulty obtaining large amounts from the corporation in the form of salary if he did little else than obtain tenants, collect rent and perform infrequent maintenance.

1. The time for inclusion or deduction is determined by the taxpayer's method of accounting, either cash or accrual.
2. As used in this article, the term "shelter" means protection from some current income tax by means of deferral.
3. However, with the recapture of accelerated depreciation which causes some gain on the disposition of certain real estate to be taxed as ordinary income, even that shelter can be forfeited. See Int. Rev. Code of 1954, § 1250, and discussion thereof infra at 73.
4. The term "control" is defined in Int. Rev. Code of 1954, § 368(c) as follows:
   For purposes of part I (other than section 304), part II, and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.
5. Subchapter S of the Internal Revenue Code is not available if more than 20% of the corporation's gross receipts constitute passive investment income. Int. Rev. Code of 1954, § 1372(e)(5).
The second way to transfer corporate funds to individual shareholders is through the distribution of corporate earnings in the form of dividends. Such distributions are not deductible by a corporation but they are fully includible in its shareholders' gross income and taxable at ordinary income rates. If the individual shareholder needs the earnings generated from the property to pay his personal expenses, it would probably be better not to have a corporation take title to the real estate, thus avoiding payment of a corporate income tax in addition to a personal income tax.

On the other hand, if the individual does not require current distributions, and he is in a high tax bracket, the lower corporate tax rates may justify having a corporation take title to the real estate. As a caveat, however, it should be noted that an accumulated earnings tax may be imposed on corporations that unreasonably accumulate earnings for the purpose of avoiding income tax with respect to their shareholders. Although further discussion of the accumulated earnings tax is beyond the scope of this article, it should be noted that in some instances, due to the different tax rates for individuals and corporations, an individual may fare better by having the corporation pay an accumulated earnings tax than by having it declare dividends.

Although tax considerations are important, one cannot lose sight of the nontax reasons for having a corporation take title to real estate. For example, during times of high interest rates it may become necessary for real estate investors to create a "straw corporation" in order to satisfy a lender who wants to bypass usury laws.

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7. IRC § 116 provides for a $100 exclusion for dividends received from domestic corporations.
8. Id., § 531.
9. Id., § 532.
11. A "straw corporation" is a corporation created solely to hold property for its beneficial owner since that owner can only accomplish certain tasks in the corporate form. The use of "straw corporations" may result in the recognition of gain on the transfer of property both to and from the corporation. See Kronovet, Straw Corporations: When Will They Be Recognized and What Should Be Done, 99 J. Tax. 64 (1978). See also Daniel E. Rogers, 94 CCH Tax Ct. Mem. 1254 (1976).
C. Common Ownership

In the case of a husband and wife, it makes no difference how title is taken for federal income tax purposes because income received from the property may be split between the spouses by their filing a joint income tax return regardless of how legal title is held. In the case of persons other than husband and wife, however, the type of tenancy ordinarily governs the income tax consequences.

1. Tenancy in Common

In this type of arrangement, each tenant in common must report his proportionate part of the gross income from the property less his proportionate part of the deductible expenses attributable to the property. Even though one tenant paid a larger share of the total expenses than his proportionate share, he is allowed to deduct only his proportionate part measured by his interest in the property. Excess payments are treated as advances to his co-owners for which he has a right of reimbursement.\(^{12}\) Similarly, gain or loss on the sale of the property is allocated among the co-owners in proportion to their interests in the property, unless there is proof of actual ownership to the contrary.\(^{13}\)

2. Joint Tenancy

A joint tenant is required to report his proportionate part of the gross income from property he owns measured by his interest in the property.\(^{14}\) Similarly, he is entitled to deduct his proportionate part of expenses attributable to the property. However, unlike tenants in common, if one joint tenant pays expenses in excess of his proportionate share, he may deduct the full amount of such expenses.\(^{15}\) Gain or loss on the sale of jointly held property is allocated among joint tenants in proportion to their interests.

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15. The reason for the different treatment of joint tenants and tenants in common is that each joint tenant is personally liable for all expenses incurred, whereas a tenant in common is personally liable for only his proportionate part of the expenses incurred. W. R. Tracy, 7 B.T.A. 1055 (1927). However, for special treatment for casualty-loss deduction, see Rev. Rul. 347, 1975-2 C.B. 70.
3. Partnership Ownership

Since a partnership is not a taxpaying entity, no additional tax liability will be incurred by having a partnership take title to real estate. All of the income and deductions ascribable to the partnership property, including depreciation, will be attributed to the partners for inclusion in their respective individual income tax returns. Each partner must report his proportionate part of the partnership’s distributive net income whether or not the income is actually received by the partner. Despite the apparent simplicity of the partnership form of ownership, a partnership constitutes an additional entity which lies between the partners and the property. Its existence may give rise to a number of complicating tax factors including gain or loss on the contribution of property to a partnership, special basis treatment and the taxation of property distributed from a partnership. Furthermore, the allowance for depreciation may be allocated among the partners in proportion to their interests in partnership capital or profits rather than in accordance with their investments in the partnership property.

III. Tax Classification of Real Estate

Real estate can be held for many different purposes. The purpose for which one holds real estate often controls the incidence of income tax with respect to it. The general tax classifications of real estate are personal residence, investment property, income producing property, property held for use in a trade or business and property held for sale to customers.

Although all the expenses incurred for personal living costs are nondeductible and depreciation deductions are not permitted for real estate held as the owner’s personal residence, certain expenses incurred are deductible. These expenses in-

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17. Id., § 702.
18. Id., § 721.
19. Id., §§ 734 and 743.
20. Id., §§ 731, 735, 736 and 751.
23. Id., § 167(a).
clude real estate taxes,\textsuperscript{24} interest on mortgage indebtedness\textsuperscript{25} and casualty losses.\textsuperscript{26} An owner's sale of residential real estate creates either a capital gain or a nondeductible personal loss.\textsuperscript{27}

Property held for investment generally includes unimproved real estate held for capital appreciation. Although depreciation is not an allowable deduction for improved real estate which is not held for the production of income,\textsuperscript{28} the expenses of managing and conserving such property are deductible.\textsuperscript{29} Real estate taxes imposed upon property held for investment may be capitalized or deducted at the option of the owner.\textsuperscript{30} Gains and losses from the sale or exchange of property held for investment are capital in nature.\textsuperscript{31}

Real estate held for the production of income is treated similarly to property held for investment except that a depreciation deduction may be taken for property held for the production of income. Since it is the "purpose" for which real estate is held that controls its tax classification, the fact that no income is actually produced is immaterial. Accordingly, property held for rent will qualify as real estate held for the production of income, even if the real estate stands vacant for a period.\textsuperscript{32}

All expenses incurred with respect to property held for use in a trade or business are deductible.\textsuperscript{33} Upon the disposition of trade or business property gain is treated as prescribed in section 1231 (often referred to as the "taxpayer's friend").\textsuperscript{34}

Property held for sale to customers in the ordinary course of a trade or business is accorded ordinary income treatment. As with property held for use in a trade or business, all expenses incurred with respect to property held for sale to customers

\footnotesize{
\textsuperscript{24} Id., § 164.
\textsuperscript{25} Id., § 163.
\textsuperscript{26} A deduction for a casualty loss includes loss by theft, fire, explosion, tornado, lightning, etc., to the extent the loss in each occurrence exceeds $100. See Int. Rev. Code of 1954, § 165.
\textsuperscript{27} Id., § 162.
\textsuperscript{28} Id., § 167.
\textsuperscript{29} This is true even though the property is not productive, will probably not be sold at a profit, or is held primarily to minimize a loss. See Int. Rev. Code of 1954, § 212.
\textsuperscript{30} Id., § 266.
\textsuperscript{31} Id., §§ 1221, 1231 and 165(c)(2).
\textsuperscript{32} William C. Horrmann, 17 T.C. 903 (1951).
\textsuperscript{33} Int. Rev. Code of 1954, § 162.
\textsuperscript{34} See discussion infra at 68.
}
are deductible. However, depreciation is allowed only if the property also produces income or is held for the purpose of producing income, rather than sale to customers.

IV. Taxability of Sales or Exchanges

A. Realized and Recognized Gains

Gain is "realized" from a sale or exchange of real estate when the selling price exceeds the seller's adjusted basis in the property. Conversely, when the seller's adjusted basis is greater than the sales price, a loss is "realized."

Gain realized from a sale or exchange of real estate is always "recognized" unless a specific exemption is set forth in the law. For example, under certain circumstances gain from the sale of a personal residence is not recognized.

B. The Basis of Property

One's basis for property is dependent upon the manner of its acquisition. Where real estate is purchased, the buyer's basis is his cost for the property, but where the real estate is inherited, the devisee's basis is the fair market value at the date of the decedent's death or at the alternate valuation date, whichever value was accepted on the decedent's federal estate tax return. A donee's basis for appreciated real estate is the donor's cost of the property plus any federal gift tax paid; but a donee's basis cannot exceed the property's fair market value at the date of the gift. Where the donee sells the real estate at a loss, the donee's basis is the lesser of the donor's cost or the property's fair market value at the date of the gift. This rule reduces the amount of any loss by excluding losses suffered during the donor's ownership of the property.

The original basis of property includes the amount of any mortgages at the time the property is acquired. Such is the case

38. Id., § 1002.
39. Id., § 1034 discussed infra at 84. Other exceptions are set forth in §§ 1031, 1033, 351 and 721.
40. Id., § 1012.
41. Id., § 1014(a), and Rev. Rul. 215, 1956-1 C.B. 324.
43. Id., § 1015(a).
whether the mortgage is a purchase money mortgage, an assumed mortgage, or the property is acquired subject to an existing mortgage. One's original basis is adjusted downward by the depreciation allowed or allowable and is increased by the cost of additions, improvements and acquisitions to the property.

C. Capital Gains and Losses

Capital gain rates apply only to the sale or exchange of capital assets. Section 1231 treats certain other assets as though they were capital assets for purposes of taxing gain on their sale, exchange or involuntary conversion. These “section 1231 assets” are: (1) depreciable property used in a trade or business held for more than six months and (2) real property used in the trade or business which is not part of inventory or held primarily for sale to customers. If recognized gains on section 1231 assets exceed recognized losses involving such property during the taxable year, all such gains and losses are treated as long-term capital gains and losses. However, if recognized losses on section 1231 assets exceed the gains involving such property, all such gains and losses are treated as ordinary gains and losses.

V. Taxation of a Real Estate Dealer’s Property

Property held by a taxpayer primarily for sale to customers in the ordinary course of business is not a capital asset. Thus, dealers in real estate must pay tax at ordinary income rates on gains from the sale of their assets held for sale in the ordinary

44. Crane v. Commissioner, 331 U.S. 1 (1947). However, interest paid on the mortgage and real estate taxes—both of which are deductible—are not included in the basis. See Colonial Enterprises, Inc., 47 B.T.A. 518 (1942); Int. Rev. Code of 1954, § 1012.


46. Id., § 1221. Capital assets include all property of a taxpayer except inventory assets, property held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business, depreciable business property, real estate used in the taxpayer’s trade or business, short-term noninterest-bearing government obligations issued on a discount basis, a copyright, literary, musical or artistic composition, a letter or memorandum, or similar property, held by the person whose efforts created it, or by a transferee whose basis is computed by reference to that of the property’s creator, and accounts or notes receivable acquired in the ordinary course of business for services rendered or sale of stock in trade.

47. If the casualty gains exceed the casualty losses, the net gains are treated as § 1231 assets.

course of business. The question of whether or not a person is a real estate dealer, or merely an investor in real estate, is a close one where transactions in real estate are numerous. The courts look to the intent of the taxpayer at the time of sale as well as the time of acquisition of the property and a number of other factors. A real estate broker who contends that particular property is subject to capital gain must show that he treated the alleged investment property differently from the property which he held primarily for sale to his customers in the ordinary course of business.

Since section 1221 defines capital assets in relative terms as not including property held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business, it is not surprising the definition has been the subject of frequent litigation. In Malat v. Riddell, the Supreme Court defined the term “primarily” in the phrase “primarily for sale to customers” in section 1221. Malat was a member of a joint venture which acquired a forty-five acre tract of land intending to develop it and hold it for rental. The zoning changes and financing necessary to complete the development were not obtained. After selling some interior lots and reporting the profit as ordinary income, Malat sold his interest in the undeveloped land and reported the profit as capital gain. The Supreme Court, in resolving a conflict among the courts of appeals, determined that the term “primarily” means “of first importance” or “principally” and remanded the case to the district court for fresh findings of fact.

In Scheuber v. Commissioner, a husband and wife engaged in the real estate business purchased an unimproved tract of land in a potentially commercial area in 1950, advertised it for sale and sold half the land in 1958 and half in 1959. The taxpayer contended the property was purchased for eventual sale after appreciation in value to provide a retirement annuity. The court first determined that a real estate dealer should not have any higher burden of proof to show that he held property for investment purposes than an ordinary investor. The court then found that the taxpayer’s continuous intent to sell the land was immaterial, the gain realized by the taxpayer was

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51. 371 F.2d 996 (7th Cir. 1967).
unrealistically high for day to day real estate operations, the taxpayer held the land for growth over a long period of time, and therefore qualified for capital gain.

In *James R. Baer*, a taxpayer was in the business of constructing dwellings since 1925. Until 1938 he built single family houses for resale. In 1938 he began building a portfolio of rental property. After 1951 all properties he constructed were for his rental account. From 1955 through 1958 the taxpayer sold twenty-two rental units the holding periods of which were from twenty to sixty-one months. The construction always took place on land already owned by the taxpayer. Gains were taxed as capital gains because the buildings were held for rental purposes, not for sale to customers in the ordinary course of business, with the Tax Court stating:

The question of whether property is held principally for use in a taxpayer's trade or business as opposed to being held primarily for sale to customers is one of fact. We are persuaded by all of the evidence presented that petitioner's primary purpose in holding the properties in issue was to rent them out and not to sell them. The majority of the properties involved were profitably rented for substantial periods of time prior to being sold. The sale of each was prompted by bona fide business reasons, including a desire to improve the overall quality of his investment, on petitioner's part and accomplished with a minimum of sales activity by petitioner himself. We find that all of the properties in issue were 'used in the trade or business' of petitioner within the meaning of Section 1231(b) of the Code.

The foregoing cases discussed seem to imply that "holding primarily for sale" means sale in the relatively near future. However, a review of the following cases on the "dealer" question illustrates rather clearly the volatile nature of this area of the tax law.

In *Juleo, Inc. v. Commissioner*, the Third Circuit held that where a real estate development corporation ceased further development of land upon learning of the state's plan to condemn the property, a later sale to the state was taxed as ordinary income. The court reasoned that a condemnation notice

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53. Id., at 1282.
54. 483 F.2d 47 (3d Cir. 1973).
does not change land held primarily for sale to customers in the ordinary course of business into capital assets. The court disregarded the fact that no improvements or sales were made for eight years prior to the sale to the state.

In Maurice F. Fabiani, the court found that land originally purchased for sale in the ordinary course of business changed into investment property prior to actual receipt of a notice of condemnation and, therefore, qualified for capital gain. The court distinguished this case from Juleo on the grounds that Fabiani, after the purchase of the property, never filed subdivision maps nor did any engineering work, and never advertised for sale nor sold any of the property. The facts indicate that about five years before formal notice of condemnation the taxpayer was made aware of the possibility of the United States Government's building a dam which would require the forced sale of the property. From the facts of the case, it would be fair to assume that the taxpayer's lack of activity was due to apprehension and not change of purpose.

The issue was again before the courts in four recent cases, Rockwell v. Commissioner, Westchester Development Company, Biedenharn Realty Co. v. United States and Richard H. Pritchett. In Rockwell, the taxpayer sold or exchanged twelve pieces of real estate from 1963 through 1967. With respect to the “dealer” issue, the Tax Court stated:

[In determining whether property is held primarily for sale, the fact that it was not originally acquired for resale is not controlling. Rather, the test is whether the property was primarily held for sale when the sale was made. See Klarkowski v. Commissioner (CA7) 385 F.2d 398, and Estate of Peter Finder, 37 T.C. 411.]

The numerous real estate transactions to which the taxpayer was a party during the period in question, coupled with an

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56. 512 F.2d 882 (9th Cir. 1975), aff'g Michael L. Rockwell, 31 CCH Tax Ct. Mem. 596 (1972).
57. 63 T.C. 198 (1974).
58. 509 F.2d 171 (5th Cir. 1975), rev'd on rehearing, 526 F.2d 409 (5th Cir. 1976).
60. 31 CCH Tax Ct. Mem. at 699. Compare the apparent implication in Malat v. Riddell, 383 U.S. 569 (1966), and text accompanying note 50 supra. See also Estate of Walter K. Dean, 34 CCH Tax Ct. Mem. 631 (1975), regarding the effect of changed taxpayer intent.
apparent lack of any other significant income-producing activity, led the Tax Court to the conclusion that the taxpayer was then engaged in the real estate business and thus the gain was ordinary income. In finding that the Tax Court was not clearly erroneous, the Ninth Circuit Court of Appeals affirmed, noting:

It is rare indeed that one will find any precedent value in applying the decision of one case to the facts of another case. At the most, other cases decided by the courts on this subject may be persuasive or suggestive of the approach of the courts to cases where the facts may be somewhat similar.\(^6\)

In *Pritchett*, the taxpayer kept business properties in the names of business entities and personally held investment real estate. Recognizing the factual nature of the issues, the court noted the following nine factors: (1) purpose of acquisition; (2) purpose for subsequent holding of property; (3) extent taxpayer improved the property; (4) frequency, number and continuity of sales; (5) extent and nature of transactions involved; (6) taxpayer's ordinary business; (7) efforts used to solicit buyers; (8) listing of property with brokers; and (9) purpose for holding property at time of sale.\(^6\) The court found each of the four sales by the taxpayer had resulted from an unsolicited offer to buy, with no attempt to subdivide, improve, advertise, or sell the properties and the sales were not made in the ordinary course of the taxpayer's business as a broker. Accordingly, the taxpayer's profit was taxed at capital gain rates. In both *Westchester* and *Biedenharn*, the court decided the taxpayer qualified for capital gain treatment based upon the facts.

In order to avoid having gain treated as ordinary income, taxpayers might consider liquidation of an investment through an independent contractor. In *Voss v. United States*,\(^6\) the taxpayer purchased land for investment purposes but found many years later that subdividing the property was the only way to sell the property profitably. Accordingly, he turned over all control of subdivision activities to a real estate broker, and continued in the active practice of dentistry. Based upon the broker's independence and taxpayer's lack of participation in the subdivision activities, the court found the taxpayer did not

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61. 512 F.2d at 884, quoting Los Angeles Extension Co. v. United States, 315 F.2d 1, 3 (9th Cir. 1963).
63. 329 F.2d 164 (7th Cir. 1964).
hold the property for sale to customers in the ordinary course of a trade or business.

Use of an independent contractor may not be the only possible route of safety to capital gain. A broker who invests in real estate for himself may be well advised to establish another entity to acquire investment property. Doing so may help to defeat a contention of dual purpose for acquisition, and the dealer status may thereby be avoided.\(^6\)

Section 1237 of the Internal Revenue Code, which applies only to noncorporate taxpayers, sets forth specific criteria for determining how a subdivider of real estate must report gain from the sale of real estate. If a subdivider holds real estate for at least five years (unless inherited) to which he does not make substantial improvements\(^6\) and which he either has not held primarily for sale to customers in the ordinary course of business or does not so hold any other real estate in the taxable year the sale occurs, then the subdivider will not be treated as a dealer due solely to the subdivision. If these criteria of section 1237 are met, gain from the sale of the first five lots sold will be taxed as capital gain. In years when subsequent sales are made, five percent of the gain will be ordinary income and the balance will be capital gain.

**VI. Depreciable Real Property and Section 1250**

Prior to 1964, taxpayers could take accelerated depreciation\(^6\) on real property used in business or held for the production of income. Upon the sale of the property, the gain was taxable as capital gain. Thus, even though holding the property for a period less than the depreciable useful life, the taxpayer could depreciate the whole cost of the property and sell it while it still had a substantial actual useful life remaining. In effect, the taxpayer was taking depreciation deductions against ordinary income and only paying tax on capital gain. In 1964, section 1250 of the Internal Revenue Code was enacted to close

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64. A recent article on the “dealer” issue analyzes the case law in this area, proposes practical rules for meeting the evidentiary burden and suggests planning techniques. Comment, When a Dealer’s Real Estate Sales May Qualify for Capital Gain Treatment Under Section 1221(1), 57 Marq. L. Rev. 691 (1974).

65. Water, sewers or roads are not substantial improvements if the land is held for 10 years and their cost is not added to the taxpayer’s basis. Int. Rev. Code of 1954, § 1237(b)(3).

66. Accelerated depreciation and the other various methods of depreciation are discussed infra at 75.
this "tax loophole." Further restrictions and limitations with respect to the depreciation of real property were enacted by the Tax Reform Act of 1969.\textsuperscript{67}

Section 1250 created a classification of property, commonly known as section 1250 property, which is defined as any real property depreciable under section 167 of the Internal Revenue Code that is not subject to the recapture rules under section 1245.\textsuperscript{68} Even though section 1250 property may not be subject to depreciation in the taxpayer's hands, it is still classified as section 1250 property if depreciation deductions were taken by a prior owner and were taken into consideration in determining the adjusted basis of the property in the hands of the present owner. For example, if a father uses a house 100 percent for business and then gives the house to his son as a gift for the son's personal use, section 1250 would apply to a subsequent sale of the house by the son because of the carryover basis applicable to the property in the hands of the son.\textsuperscript{69}

The operational provisions of section 1250 are such that gains from the sale or other disposition of section 1250 property are taxed as ordinary income to the extent that depreciation after 1963 exceeds what the straight-line depreciation would have been if the straight-line method had been used. If the section 1250 property has been held twelve months or less, all the depreciation taken on the property is recaptured and treated as ordinary income. However, whether or not the property has been held for more than twelve months, the amount to be taxed as ordinary income is limited to the actual gain on the transaction. For example, where the sales price is $50,000 and the adjusted basis is $49,000, the gain therefrom is $1,000. Even if the excess depreciation (the depreciation taken in excess of what would have been taken if the straight-line method had been used) was $5,000, section 1250 would not create additional gain; it would merely convert what would otherwise have been $1,000 of capital gain to ordinary income. The amount to be taxed as ordinary income under section 1250 depends upon the length of time the real estate has been held, the nature of the real estate, and the date of its acquisition.\textsuperscript{70}

\footnotesize
\textsuperscript{67} See Int. Rev. Code of 1954, § 167(j), and text at 75-77 infra.
\textsuperscript{68} Section 1245 refers generally to the recapture of depreciation on personal property.
\textsuperscript{69} See discussion of basis of gifted property \textit{supra} at 67.
\textsuperscript{70} See text at 78-80 infra.
A. Methods of Depreciation Available for Real Estate Acquired After July 24, 1969

1. Straight-Line Depreciation

Under the straight-line method of depreciation, the cost or basis of the property is deductible from gross income in equal annual installments over the useful life of the asset. Assume a taxpayer purchased land and a building for $15,000. Ten thousand dollars was allocated to the building, and the estimated useful life of the building is ten years. The annual depreciation would be at a rate of ten percent (100 percent divided by ten years) or $1,000 each year for the ten year period.

The straight-line method of depreciation may be used for any real estate including residential rental and commercial property regardless of its useful life.

2. Declining Balance Method of Depreciation

Under the declining balance method of depreciation a constant rate (in excess of the straight-line rate) is applied to the unrecovered basis of the property to compute the depreciation deduction. For example, the taxpayer purchases the same land and building for $15,000 as in the above example, of which $10,000 represents the building. Using an estimated useful life of ten years, the depreciation deductions under the declining balance method would be as follows:

Example of 150 Percent Declining Balance Method

(a) Year 1 $10,000 x 15% = $1,500
    Basis $10,000
    Less Depreciation Allowance $1,500
    Remaining Basis $ 8,500
(b) Year 2 $8,500 x 15% = $1,275
    Adjusted Basis $ 8,500
    Less Depreciation Allowance $ 1,275
    Remaining Basis $ 7,225
(c) Year 3 $7,225 x 15% = $1,083.75
(d) Etc. through year 10.

The 200 percent declining balance method of depreciation may be used only with respect to new section 1250 property qualifying as "residential rental" property. The 150 percent declining balance method of depreciation is the maximum allowed on all other new commercial property. The 125 percent declining balance method of depreciation applies to used "resi-
dential rental” property with a remaining useful life of twenty years or more.71

3. Sum-of-the-Years-Digits Method of Depreciation

The sum-of-the-years-digits method of depreciation is computed by applying a fraction to the cost or basis of the property. The denominator of the fraction remains fixed, being equal to the sum of all digits comprising the number of years of the estimated useful life. The numerator of the fraction decreases each year from the estimated useful life to the remaining useful life. Using the example in the above two methods, the cost of the depreciable property purchased by the taxpayer is $10,000 with a useful life of ten years. The sum of the digits one through ten makes up the useful life of ten years (1 + 2 + 3 + 4 + 5 + 6 + 7 + 8 + 9 + 10 = 55). Accordingly, the computations to determine the amount of depreciation would be:

a. \( \frac{10}{55} \times 10,000 = 1,818.18 \)

b. \( \frac{9}{55} \times 10,000 = 1,636.36 \)

c. \( \frac{8}{55} \times 10,000 = 1,454.54 \)

d. etc.

The sum-of-the-years-digits method of depreciation is only applicable to new section 1250 “residential rental” property. To constitute “residential rental” property, at least eighty percent of the gross rental income from the building must be rental income from dwellings. “Dwelling units,” for this purpose, do not include units in hotels, motels or other establishments in which more than half the units are used on a transient basis. The intent and purpose of the statute is to encourage the construction of residential property catering to people looking for a “home,” as opposed to just temporary quarters, such as are furnished in a hotel, motel or similar establishment. The building will still qualify as “residential” if more than half the dwelling units are for permanent-type housing. If the “eighty percent gross rental test” is met, the balance of the rental income can come from other sources, such as rental income from stores in the building.

4. Component Method of Depreciation

The component method is yet another way to calculate a depreciation deduction. The basis for this method of depreciation lies in the Income Tax Regulations.\textsuperscript{72} The advantage of its use is that those components whose useful lives are quite short may be completely depreciated over a reduced period, rather than depreciating such components over the full life of the composite piece of depreciable property. A side effect of using the component method is the probable necessity to increase the estimate of useful life assigned to the composite piece of property absent its separately depreciated components.\textsuperscript{73}

The depreciable property may be accounted for, under this method, by treating each individual item as an account, or by combining two or more assets in a single account.\textsuperscript{74} Assets may be grouped in an account in a variety of ways, within prescribed limits.\textsuperscript{75}

Clearly, where the taxpayer is the first user of property and the actual costs of the separate components are generally known and properly allocated, costs may be used by him as a basis for depreciating the components separately, using an appropriate rate of depreciation for each of the separate components.\textsuperscript{76} The component method of accounting for depreciation of \textit{used} real property improvements may be utilized if the cost of acquisition is properly allocated to the various components based on their values and useful lives are assigned to the component accounts based on the condition of such components at the time of acquisition.\textsuperscript{77}

\textsuperscript{72} Treas. Reg. § 1.67(b) (1956).
\textsuperscript{73} Rev. Rul. 4, 1968-1 C.B. 77.
\textsuperscript{74} For the acquisition of a combination of depreciable and nondepreciable property for a lump sum, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum purchase price as the value of the depreciable property, at the time of acquisition, bears to the value of the entire property at that time. \textit{See} Treas. Reg. § 1.167(a)-5 (1956).
\textsuperscript{75} Id., § 1.167(a)-7.
\textsuperscript{76} See Rev. Rul. 111, 1966-1 C.B. 46, and Herbert Shainberg, 33 T.C. 241 (1959), acq., 1960-1 C.B. 5. In Rev. Rul. 66-111, the I.R.S. also ruled that the basis of used real property ordinarily cannot be allocated to separate component accounts for the purposes of determining a composite life in computing depreciation allowances.
\textsuperscript{77} Rev. Rul. 410, 1973-2 C.B. 53. This position appears to be based upon Harsh Investment Corp. v. United States, Civil No. 69-154 (D. Ore., Jan. 9, 1970), 71-1 CCH U.S. Tax Cases, ¶ 9183 at 85,798, where the taxpayer purchased a combination of depreciable and nondepreciable property. Thereafter, it retained the services of a
B. Section 1250 Recaptured Depreciation—Computation

1. Regular Computation

The computation of recapture pursuant to section 1250 normally involves three steps. The first is to calculate the additional (excess over straight-line) depreciation for the years following 1969. If the excess post-1969 depreciation is greater than the gain on the sale, the recaptured depreciation will be limited to the gain on the sale. If the post-1969 depreciation is less than the gain on the sale, all of the post-1969 depreciation is recaptured and then combined with the amount of the pre-1970 recaptured depreciation determined in the second step.

The second step is to calculate the pre-1970 recaptured depreciation in the following manner:

a. 100 percent of all depreciation is recaptured if the property sold was held less than twelve months.

b. 100 percent of the additional (excess over straight-line) depreciation is recaptured if the property was held less than twenty months.

c. Decrease the recaptured depreciation by one percent for each month the property was held in excess of twenty months.

d. If the property was held more than 120 months (ten years) none of the pre-1970 depreciation is recaptured.

The third step is to add the post-1969 depreciation recaptured to the pre-1970 depreciation recaptured, and report the lower of that sum or the amount of the gain on the transaction as ordinary income. For example, if property was sold in 1976 at a gain of $10,000 and the post-1969 excess depreciation was 100 percent of all depreciation recaptured, the recapture would be limited to the gain on the sale of $10,000.

reputable firm of appraisers to allocate the value between the two types of property as of the date of purchase. It then employed the component method of depreciation in arriving at the depreciation deductions for the tax years in question. The district court found that the taxpayer was entitled as a matter of law to use the component method of depreciation. Its decision was based upon the competent expert testimony presented by the taxpayer. Accordingly, laying a firm basis for allocation of costs between depreciable and nondepreciable parts of property can bear fertile fruit.

Rev. Rul. 73-410 was further modified by Rev. Rul. 55, 1975-1 C.B. 74. The issue presented in the ruling was whether a taxpayer is generally limited to straight-line depreciation or, in the case of a building where useful life is greater than 20 years, 125% declining balance, at his election. The ruling holds that where component depreciation is used for buildings acquired after July 24, 1969, one of those two methods must be used for the various "structural components" of the building, as that term is defined in Treas. Reg. 1.48-1(e) (1965). See also INT. REV. CODE OF 1954, §§ 167(j)(4) and (5).
$5,000 and the pre-1970 excess depreciation was $7,500, the total gain of $10,000 would be taxed as ordinary income.

2. Residential Housing Recaptured Depreciation

Rental housing has been given special treatment in the area of depreciation recapture. It is allowed a special reduction in the amount of depreciation that will be recaptured upon its sale. If residential rental property is held for less than twelve months, 100 percent of all depreciation must be recaptured (not just the additional depreciation) upon its sale. Where property is held for less than twenty months but more than twelve months, 100 percent of the additional depreciation must be recaptured. If property is held for less than 100 months, 100 percent of the post-1969 excess depreciation is recaptured and 100 percent, less one percent for each month the property is held over twenty months, is recaptured for pre-1970 excess depreciation. For property held more than 100 months, the post-1969 excess depreciation is recaptured 100 percent, less one percent for each month the property is held over 100 months. Therefore, after sixteen years and eight months (200 months) residential rental property may be disposed of without any recapture of depreciation.

3. Holding Period

The amount of time one has held property is required knowledge for purposes of determining whether capital gain or ordinary income is applicable to a transaction, as well as calculating the amount of depreciation recapture.

There are special rules which apply to determine the holding period for section 1250 property. The holding period begins on the day following the acquisition of property. However, if property is constructed, the holding period begins on the first day of the month in which the property is placed in service. Where property has a substituted or carryover basis in the hands of the seller, his holding period includes the holding period of his transferor.

78. Note that the post-1969 depreciation is always calculated first, and then, if any gain remains, the pre-1970 depreciation is recaptured.
4. **Tax Free Exchanges and Section 1250**

Where there is a tax free exchange under sections 332, 351, 361, 721 or 731, the amount of ordinary income recognized may not exceed the amount of gain recognized to the transferor determined without regard to section 1250. However, section 1250 gain is recognized in a section 337 liquidation despite its tax free nature.

**C. Sales of Depreciable Property to Related Interests**

Section 1239 acts to deny capital gain benefits upon the transfer of depreciable property between related interests. It also has as a purpose the prevention of sales of depreciable property to related interests taxed as capital gain while the purchaser obtains depreciation benefits at an increased basis.

The statute applies to sales and exchanges directly or indirectly between a husband and wife, or between an individual and his corporation if he, his spouse and minor children and minor grandchildren own more than eighty percent of the stock. Note, however, that the rule only affects property subject to depreciation; it does not affect unimproved land.

**VII. INSTALLMENT SALES**

**A. General**

Section 453 of the Code allows eligible sellers of real estate to report gain periodically rather than all at once in the year of the sale. The section applies to any sale of real estate, where the initial payment in the taxable year of the sale does not exceed thirty percent of the selling price.

**B. Computation of Initial Payment**

The “initial payment” (payments received in the year of sale) includes cash or other property received, except evidence of indebtedness of the purchaser. The initial payment also includes indebtedness assumed in excess of the seller’s cost. On the other hand, it is not necessary that the seller receive any

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81. *Id.*, § 1250(d)(3).

82. *Id.*, § 1250(a).

83. The rules of relationship set forth under § 1239 are not the same as those under § 267 of the Code (losses between related parties). A similar rule also applies to partnerships. See Int. Rev. Code of 1954, § 707(b)(2).

84. It is immaterial whether the indebtedness is assumed or the property is taken subject to the indebtedness.
part of the payment in the year of sale to qualify under section 453.\textsuperscript{55}

**C. Selling Price**

The “selling price” is the total consideration received, including mortgages on the property. Knowledge of the selling price is necessary in order to determine whether the above-mentioned thirty percent limit on initial payment in the taxable year of sale will be met.\textsuperscript{55}

**D. Computation of Reportable Profit**

Under the installment method of reporting income, the percentage of each payment made to the seller is reported on his income tax return based upon the ratio of his total profit to the “contract price.” His profit is the difference between the selling price and the seller’s basis in the property. The contract price is the selling price less the mortgage assumed or to which the property is subject.\textsuperscript{57} However, if the mortgage exceeds the seller’s basis, then this excess is added to the selling price to obtain the “contract price.” The following is an example:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling Price</td>
<td>$105,000</td>
</tr>
<tr>
<td>Selling Expenses</td>
<td>5,000</td>
</tr>
<tr>
<td>Net Amount Received</td>
<td>$100,000</td>
</tr>
<tr>
<td>Basis of Property</td>
<td>60,000</td>
</tr>
<tr>
<td>Gross Profit to be Realized</td>
<td>$ 40,000</td>
</tr>
<tr>
<td>Gross Profit Percentage</td>
<td>[\frac{40,000}{60,000}] 66.67%</td>
</tr>
</tbody>
</table>

\textsuperscript{55} INT. REV. CODE OF 1954, § 453(b)(2)(i).

\textsuperscript{56} In Richard H. Pritchett, 63 T.C. 149 (1974), the taxpayer sold two contiguous parcels of land. The Commissioner claimed there were two separate sales, one of which exceeded the 30% limit. The Tax Court upheld the Commissioner, citing Treas. Reg. 1.453-5 (1967).

\textsuperscript{57} For opposing treatment of selling expenses as a factor in qualifying for the installment method see Kirschenmann v. Commissioner, 488 F.2d 220 (9th Cir. 1973), and Rev. Rul. 384, 1974-2 C.B. 182. However, for their treatment in residential sales, see Treas. Reg., § 1.1034-1(b)(4) (1956).
Assume $30,000 payments received in taxable year; reportable profit equals 66.67% x $30,000 = $20,000.

E. Timely Election Required

The benefits of the installment method of reporting income are available only if the seller makes the proper election. Although a timely election to report income on the installment method should be made on the return with respect to the year of sale, the election may be made later if the taxpayer fails to make any election on his original return.88

VIII. Tax Free Exchanges—Section 1031 IRC

A. Nonrecognition of Gain or Loss

Normally the fair market value of property received in an exchange is considered the equivalent of cash, and the tax consequences would be the same as those of a sale.89 Section 1031 of the Code, however, provides for certain tax-free exchanges. In exchange for its benefits, the statute requires that the property exchanged be held for productive use in a trade or business or investment and that the exchange be solely for property of a “like kind” to be held for productive use or investment. Certain types of property are excluded from section 1031, such as stock in trade, property held primarily for sale to customers (real estate held by a broker) and stocks, bonds, notes, choses in action90 or other evidences of indebtedness or interest.

B. Meaning of “Like Kind”

The term “like kind” as used in section 1031 has reference to the nature or character of property, as opposed to the grade or quality. Examples of tax-free exchanges under section 1031 include urban real estate for rural real estate, a leasehold of a fee with over thirty years to run for real estate, improved real estate for unimproved real estate91 and the disposition of property for the transferee’s promise to convey “like kind” property

88. The procedure to be followed is the filing of an amended return or a claim for refund. However, at such time the entire year is also still open for audit purposes. Accordingly, the wise seller will make his election without delay.
90. Choses in action refer to rights to personal things not possessed by the owner. See Black's Law Dictionary 305 (4th ed. revised 1968). Since the rights of a buyer under a land contract deal with real estate in buyer's possession, they are not classified as choses in action. Thus a buyer's rights under a land contract can be exchanged tax-free for other real estate if both parcels meet the use or investment requirements of § 1031.
at a future date. However, section 1031 is not applicable to the exchange of a general partnership interest for a limited partnership interest, even though the underlying property of both partnerships is real estate.

C. Exchanges Not Solely in Kind

Where parties exchange "like kind" property but one of them receives other property in addition to the "like kind" property in order to equalize the transaction, the exchange is then only partially tax free. (The term "boot" is used to refer to the other property.) Gain is then recognized to the recipient of the boot to the extent of the boot received, with a limitation that such recognized gain may not exceed the amount of actual gain realized upon the exchange. For example, P received a building with a fair market value of $30,000 and $20,000 cash and the adjusted basis of the building he transferred was $40,000. Although P received boot of $20,000, he need only recognize the gain to the extent of the economic benefit received, $10,000 ($50,000 less $40,000).

Another situation involving boot exists where two parties, P and Q, exchange "like kind" property but P assumes Q's mortgage. Again, the exchange is partially tax free with gain recognized to the extent that Q has been relieved of his obligation to repay his mortgage. The following example illustrates this computation:

Fair market value of property received by Q $ 75,000
Money or other property received
(P's assumption of Q's mortgage) 25,000
Total consideration received $100,000
Basis of property given up $ 60,000
Gain realized by Q $ 40,000
Gain recognized by Q (value of unlike property up to gain realized) $25,000

It is not uncommon for two parties to exchange property where each takes the other's property subject to existing mort-

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93. Estate of Meyer v. Commissioner, 503 F.2d 556 (9th Cir. 1974). The court held that the different character of the ownership interests made them property of a different class rather than property of a different grade and thus there was not a like kind exchange.
gages. Obviously, if the mortgages on the respective properties are equal, the exchange remains tax free. However, if one mortgage exceeds the other, the party who has received mortgage relief must recognize gain to the extent of the relief.\(^4\) Example: \(P\) owns a building with a fair market value of $50,000 and a mortgage of $15,000. His basis in the building is $40,000. \(Q\) owns a building with a fair market value of $60,000, a mortgage of $25,000 and his basis in the building is $50,000. Each has an equity in his building of $35,000. If they were to exchange buildings, each would be receiving the same equity as he transferred. The tax consequences, however, would be as follows:

\[
\begin{array}{cc}
\text{Fair market value of property received} & P & Q \\
\text{Net money or other property received} & $60,000 & $50,000 \\
\text{(net assumption of other party's mortgage)} & -0- & 10,000 \\
\text{Total consideration received} & $60,000 & $60,000 \\
\text{Basis of property exchanged} & 40,000 & 50,000 \\
\text{Gain realized} & $20,000 & $10,000 \\
\text{Gain realized} & -0- & $10,000 \\
\end{array}
\]

**D. Basis**

The basis of property acquired in a tax-free exchange is the same as the basis of the property exchanged.\(^5\) Thus, the basis of property one transfers in a section 1031 exchange is substituted as the basis for the property he receives in the exchange. Adjustments are required for boot, however. Such adjustments would decrease the basis by any money or other boot received and increase it by the amount of any gain recognized.\(^6\)

**IX. Sale and Purchase of Residence**

**A. Nonrecognition of Gain - Section 1034**

1. **Qualification**

Section 1034 provides for the nonrecognition of gain resulting from the sale of a taxpayer's residence if he purchases an-

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\(^4\) Treas. Reg. § 1.1031(b)-1(c) (1967). Whether the property exchanged is taken subject to a mortgage or the mortgage is assumed is immaterial.


other residence within eighteen months\textsuperscript{97} before or after the sale. The replacement may be made by exchange\textsuperscript{98} or construction.\textsuperscript{99} The requirements with regard to construction are that it must be commenced within eighteen months\textsuperscript{100} before or after the sale of the principal residence and that occupancy in the newly-constructed residence must be within two years\textsuperscript{101} of the sale of the old residence.

The statute requires that the old and new residences be occupied as the principal residence of the taxpayer.\textsuperscript{102} In Robert G. Clapham,\textsuperscript{103} the taxpayer vacated his principal residence in August 1966 and bought a new residence in September 1968. In June 1969, the residence vacated in 1966 was sold. The court held the long period between vacation and sale did not disqualify the property as the taxpayer's principal residence. Accordingly, gain on the sale was not required to be recognized.

The statute provides that gain will be recognized only to the extent that the adjusted sales price of the old residence exceeds the cost of the new residence. The "adjusted sales price" is the net amount realized from the sale, i.e., the selling price less selling expenses such as a broker's commission and fix-up expenses.\textsuperscript{104}

Although fix-up expenses are personal in nature and not considered in determining the amount of gain realized on the sale of one's principal residence, they are considered in determining the adjusted sales price. The following example is illustrative:

A. Gain realized

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$42,500</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>-$2,000</td>
</tr>
<tr>
<td>Amount realized</td>
<td>$40,500</td>
</tr>
<tr>
<td>Basis of home</td>
<td>-$20,000</td>
</tr>
<tr>
<td>Gain realized</td>
<td>$20,500</td>
</tr>
</tbody>
</table>

\textsuperscript{97} INT. REV. CODE OF 1954, § 1034(a). The replacement period was lengthened from 12 to 18 months for a principal residence sold after December 31, 1974.

\textsuperscript{98} Id., § 1034(c)(1).

\textsuperscript{99} Id., § 1034(c)(6).

\textsuperscript{100} Id.

\textsuperscript{101} Id.

\textsuperscript{102} For a somewhat abnormal situation involving the sale of two houses by two persons who jointly buy a second, see Rev. Rul. 238, 1975-1 C.B. 257.

\textsuperscript{103} 63 T.C. 505 (1975).

\textsuperscript{104} INT. REV. CODE OF 1954, § 1034(b).
B. Adjusted sales price

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$42,500</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>2,000</td>
</tr>
<tr>
<td>Fix-up expenses</td>
<td>500</td>
</tr>
<tr>
<td></td>
<td>2,500</td>
</tr>
<tr>
<td>Adjusted selling price</td>
<td>$40,000</td>
</tr>
</tbody>
</table>

C. Gain recognized

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted selling price</td>
<td>$40,000</td>
</tr>
<tr>
<td>Cost of new residence</td>
<td>35,000</td>
</tr>
<tr>
<td>Gain recognized</td>
<td>5,000</td>
</tr>
</tbody>
</table>

The statute does require that the work attributable to selling expenses be performed within ninety days prior to the date the sales agreement is signed and that payment for the work performed be on or before the thirtieth day after the sale of the old residence.

2. Basis and Holding Period of New Residence

The basis of the new residence is reduced by the amount of gain not recognized upon the sale of the old residence. For example, where the cost of the new residence is $35,000 and the gain not recognized is $2,200, the basis of the new residence is $32,800. Where any part of the gain on the sale of the old residence is not recognized because of the purchase of the new residence, the holding period of the old residence is added to that of the new residence. Since this deferral section is mandatory, a reduction in the basis of one's new house is required even though the taxpayer claims no tax benefit.

3. Purchase Price of New Residence

The purchase price of a new residence includes the indebtedness on the property, purchasing commissions and other acquisition costs. However, the value of property acquired by gift or inheritance does not constitute part of the purchase price. Reconstruction costs are taken into account as “purchase price” if they are made within the eighteen month period. Where the new residence is constructed prior to the sale of the old residence, however, a special rule applies if the sale is made within eighteen months of the completion of the new resi-

105. Id., § 1034(b)(2)(A).
106. Id., § 1034(b)(2)(B).
107. Id., § 1223(7).
dence. The construction costs incurred more than eighteen months before the sale do not constitute part of the "purchase price" for purposes of deferral under section 1034.\footnote{Id.}

B. Exclusion of Gain Over Age 65

Section 121 of the Code may apply in situations where a residence is sold by persons at least sixty-five years of age. This is an elective section which allows an individual to exclude from gross income any gain from the first $20,000 of the adjusted sales price of the individual’s personal residence. Election is by means of a statement attached to the seller's income tax return for the year of sale.\footnote{See Rev. Rul. 90-1955-1.C.B. 348, and Treas. Reg. § 1.1034-1(c)(4) (1956).} Form 2119 is also required to be submitted to the Internal Revenue Service.\footnote{See Id., § 1.6012-1(a)(3).}

The seller may make the election to exclude the gain from gross income at any time within the three years prior to the expiration of the statute of limitations with respect to the tax for the taxable year in which the sale or exchange occurred. The benefit provided by section 121 is applicable only to one sale or exchange. The statute requires that the property must have been owned and used by the individual as his principal residence for at least five years during the eight-year period preceding the sale.\footnote{Int. Rev. Code of 1954, § 121(a).}

Where the adjusted sales price exceeds $20,000, only a portion of the gain is excludable from gross income. The amount excludable is the same portion of gain as $20,000 bears to the adjusted sales price. For example, a man aged sixty-six sells his home having an adjusted basis of $20,000. He lived there continuously for the ten-year period preceding the date of sale.

\begin{verbatim}
Sales price $42,500
Broker's commission 2,000
Fix-up expenses 500 -2,500
Adjusted sales price $40,000
Ratio of $20,000 to adjusted sales price = ½
Sales price $42,500
Less broker's commission 2,000
Net sales price $40,500
\end{verbatim}

\footnote{Id.}
(Fix-up expenses not deductible in calculating profit)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less basis</td>
<td>-20,000</td>
</tr>
<tr>
<td>Net gain</td>
<td>$20,500</td>
</tr>
<tr>
<td>Excludable gain (½)</td>
<td>$10,250</td>
</tr>
</tbody>
</table>

If section 1034 applies to the sale or exchange, the amount realized must be computed and then reduced by the gain excluded from gross income.\(^{115}\)

There are special rules provided for married persons in section 121. Only one of the two spouses must satisfy the requirements as to age, ownership and use provided that they file a joint income tax return and the residence is owned as (1) a joint tenancy; (2) a tenancy by the entirety; or (3) community property.

A surviving spouse may make the election provided by section 121 if (1) the deceased spouse met the ownership and use requirement and did not make a prior election and (2) the surviving spouse is at least sixty-five years of age.\(^{118}\)

X. Conversion of Residence to Investment Use

In the case of an individual, a loss on the sale or other disposition of property is allowed only if it is incurred in a trade or business, or if it is incurred in a transaction entered into for profit. Thus, the sale of a residence may be taxable at capital gain rates but any loss on such sale would be a personal loss and, therefore, not allowable.\(^{117}\)

If a residence has been leased or otherwise appropriated to a business or profit purpose, however, a loss is allowable to the extent that the basis for the property did not exceed its fair market value at the time of conversion. Where a taxpayer actually leases his residence prior to sale, the lease may constitute a conversion to income producing property and therefore, a venture entered into for profit.\(^{118}\)

Activities which recently have been held insufficient to convert a personal residence into a business property are advertising a residence for sale or lease or merely listing the property

\(^{115}\) Id., § 121(d)(7).
\(^{116}\) Id., § 121(d)(2).
\(^{117}\) Id., § 262.
\(^{118}\) Paul H. Rechnitzer, 26 CCH Tax Ct. Mem. 298 (1967).
with a broker.\textsuperscript{119} However, in \textit{Lowry v. United States},\textsuperscript{120} the taxpayer offered the residence for sale without attempting to rent it and prevailed. The court cited Treasury Regulations 1.212-1(b) and (c) and stated that a rental offer is not a prerequisite to converting a prior residence into income producing property.\textsuperscript{121}

The basis of the property converted from residential status to a venture entered into for profit is the lower of (a) the fair market value on the date of the conversion or (b) the original cost or other basis less allowable depreciation. The reason for the lower of cost or fair market value on the date of the conversion is to eliminate any possible deduction for the period during which the property was held as a residence.

XI. Conclusion

As seen from the foregoing discussion, numerous aspects of a real estate transaction can affect its tax outcome, irrespective of the amount involved. Accordingly, to obtain the most beneficial results for one's client, a strong familiarity with the tax laws affecting a real estate transaction is essential.

\begin{flushleft}
\textsuperscript{119} Ray A. Brinker, 34 CCH \textsc{Tax Ct. Mem.} 1054 (1975).
\textsuperscript{120} 384 F. Supp. 257 (D. N.H. 1974).
\textsuperscript{121} For a recent case holding that the taxpayer did not prove the profit-inspired condition necessary for conversion, \textit{see} Ida Meredith, 65 T.C. No. 4 (Oct. 14, 1975), [1975 Transfer Binder] CCH \textsc{Tax Ct. Rep.} 3230 (decision no. 33,457), which sets forth a good review of this topic.
\end{flushleft}