Real Estate and Construction Tax Update

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8/23/2017
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BIO

Blaise Bender is a nationally recognized speaker on various tax, legal and accounting topics. A native of San Antonio, Blaise was a college professor for over twenty years. He received his B.B.A in Accounting Degree and a Master’s of Science in Finance from Texas A&M University. He also received an MPA in Taxation from UTSA and his Juris Doctor in Law from St. Mary’s University. Professor Bender is a member of the State Bar of Texas and a licensed CPA. He also possesses over six years experience in public accounting working for three of the formerly “Big Six” Accounting firms, Arthur Andersen & Co., Deloitte Touche, and Ernest and Young. Professor Bender was also a Controller, CFO and CEO in private industry. Blaise has been a licensed attorney since 1990 and a licensed CPA since 1992. Blaise was the President of the San Antonio Chapter of CPA’s in 2006-07. He is currently a member of the Texas Society of CPAs and, the State Bar of Texas. He also serves on several TSCPA committees.

Blaise’s background in recent years has focused on legislative developments both affecting federal tax matters. Specifically he has been focusing his efforts on the Affordable Care Act impacting both individuals and businesses of all sizes. He has also focused attention on the recently enacted Repairs and Capitalization Rules. He has been to Washington DC over the past several years and in recent months to lobby and discuss the tax effects of President Obama’s Health Care Reform.

Blaise has conducted over 400 continuing education seminars throughout Texas and the United States. He received numerous awards and recognition for his service including being named as one of the 2000 Outstanding Accounting Educators in Accounting by the Texas Society of CPA's and the 1998 Outstanding Continuing Education Award by the San Antonio Chapter of CPA’s. Blaise also maintains a legal consulting practice dealing with various tax, matters including individual taxes, corporate and partnership taxation, estate planning, corporate legal counsel, real estate, construction, farming, health care, business formation, mergers and acquisitions, strategic planning and business development issues.
I. Passive Activity Loss Update

A. Introduction

1. Prior to 1986, a taxpayer could generally deduct losses in full from rental activities and trades or businesses regardless of his or her participation. This gave rise to significant numbers of tax shelters that allowed taxpayers to deduct non-economic losses against wages and investment income. The Tax Reform Act of 1986 added Section 469, which limits the taxpayer’s ability to deduct losses from businesses in which the taxpayer does not materially participate and from rental activities.

2. The passive activity loss rules are applied at the individual level and extend beyond tax shelters to virtually every business or rental activity whether reported on Schedule C, Schedule F, or Schedule E, as well as to flow through income and losses from partnerships, S corporations, and trusts.

3. The passive loss limitations also apply in full to personal service corporations and also apply to closely-held C corporations with limitations.

B. General Rule

1. In implementing Section 469, Congress stated that losses (and credits) from passive trade or business activities, to the extent they exceed income from all such passive activities, generally, may not be deducted against other income such as salaries and wages or interest and dividends.

2. There are only two types of activities that are considered passive in nature:

   a. A rental activity without regard to whether or to what extent the taxpayer participates in such activity (therefore, a rental activity is treated as a passive activity, regardless of the level of the taxpayer’s participation); and

   b. A trade or business activity in which the taxpayer does not materially participate for the taxable year (See 469(c) (1)).

C. Rental Activity

1. For purposes of the passive loss rules, a rental activity is a transfer of property for compensation.

2. Generally, rental activities are per se passive activities, irrespective of whether the taxpayer materially participates in the activity. However, such activities in a real property business, like a real estate professional or real estate dealer, do not fall within this per se
category and dust could be treated as a trade or business, subject to the taxpayer meeting the material participation requirements. (See Sections 469(c) (2), 469(c) (1), 469(c) (7) (B)). The determination of whether a rental activity is a trade or business or investment is a case-by-case examination. Having said that, it is a substance over form issue. For example, the mere fact that a lease exists does not mean that the activity in question is not passive. The regulations have identified certain rental activities as a not being passive rental activities and they include the following:

a. Average period of customer use is seven days or less.

**Example**

The renting of a vacation home for less than seven days falls within the category.

b. Average period of customer use is 30 days or less and significant personal services are provided by or on behalf of the owner of the property.

**Example**

Personal services, including maid or linen services, cleaning public entrances, stairways, or lobbies and collecting and removing trash.

c. Extraordinary personal services are provided by or on behalf of the owner of the property.

**Example**

A room in the hospital or medical facility falls within the exception.

d. Rental of such property is treated as incidental to a non-rental activity of the taxpayer.

i. This exception applies to property rented to employees at the employer’s convenience and investment property that is held primarily for appreciation when the gross rental income from the property is less than 2% of the lesser of the unadjusted basis or the fair market value of such property.

e. Taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers.

**Example**

A public golf course falls within the exception.

i. The above also refers to an average period of use by customer, and that is determined by taking the aggregate or total number of days in all periods of customer use during the tax year and dividing it by the periods of actual customer use (See Reg. Section 1.469-1(e)(3)(iii)(c)). The period of customer use must be continuous or recurring right to use an item of property held in connection with her in association with the activity in question without regard to whether the customer actually uses
the property for the entire period or whether the property is pursuant to a single agreement.

f. Part of the property is used in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.

3. As such, an activity is a rental activity for a particular tax year if:

a. During the taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and

b. The gross income attributable to the conduct of the activity during the tax year represents amounts paid principally for the use of the tangible property (Reg. Section 1.469-1T (e) (3)).

D. Material Participation

A taxpayer is treated as materially participating in an activity for the tax year in question, if the participation meets one of seven tests as described under Reg. Section 1.469 – 5T(a)(1-(7):

1. Works 500 or more hours in the activity.

2. Does substantially all the work (i.e., more than 70% of the total business hours for the year are performed by the owner). “Substantially all” includes services of nonowner employees.

3. Works 100 hours and no one else does more.

4. Works 500 hours in all businesses owned. The individual is deemed to materially participate when the activity is a “significant participation activity” (SPA) for the taxable year, and the individual’s aggregate participation in all SPAs during such year exceeds 500 hours.

5. Materially participates in the activity for 5 of the last 10 years (whether or not consecutive) during the 10 taxable years that immediately precede the taxable year.

6. Participates in a personal service activity with 3 years participation. Individual materially participates in a personal service activity (e.g., accountants, lawyers, doctors, etc.) for any 3 taxable years (whether or not consecutive) preceding the taxable year.

7. Proves facts and circumstances. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the tax year.

In other words, meeting one of the seven tests above would make the activity nonpassive in nature and not subject to the general rule.
E. Exceptions

1. There are two major exceptions to the above rule and they are associated with:
   
   a. Real Estate Professionals.
   
   b. Taxpayers able to deduct up to $25,000 of rental activity from “actively managed” real estate.

2. Any passive activity loss not deductible in the current tax year is suspended and becomes deductible in a subsequent year in which the taxpayer either has:
   
   a. Net passive activity income or
   
   b. Completely disposes of the passive activity property to an unrelated party.

3. The passive activity loss rules continue to allow losses and credits from one passive activity to be applied against income for the taxable year from another passive activity (See Section 469(b)).

4. Losses associated with rental real property are limited.

Example

Oatman v. Comm., TCM 2017 – 17. The taxpayers reported 2 rental properties on their Schedule E. Property 1 reported rental income of $42,700 and expenses of $66,296. Property 2 reported no rental income and expenses of $877. The taxpayer’s AGI exceeded $100,000. The taxpayers did not attached to the passive loss limitations schedule Form 8582 and deducted the entire amount of the loss. The taxpayer’s original report AGI of $114,802. The IRS limited the rental loss by applying the PAL limitation. At no time did the IRS audit. The rental properties they merely applied the mechanical limitation. The taxpayers could not demonstrate that they fell within either of the exceptions.

F. Grouping of Passive Activities

1. Each activity whether it is a passive gain or passive loss must be reported on Form 8582 and it must be attached to the tax return. Otherwise the tax return is considered to be incomplete.

2. The taxpayer may aggregate, for passive loss purposes, two or more activities reported separately elsewhere on his or her tax return (See Reg. Section 1.469-4(c)). But defining separate activities too narrowly, or too broadly, can either lead to evasion of the passive loss rules or, more tragically, make it impossible for the investor to take advantage of the relief provisions afforded him or her under the passive loss regulations.

3. It is necessary to identify separate activities of the taxpayer for the following reasons:
   
   • Determining whether the activity is a rental activity
• Determining whether the taxpayer did in fact materially participate in the activity.
• Determining whether the taxpayer has completely disposed of the entire interest in the activity.
• Applying transition rules for pre-enactment interest.

4. The following factors are giving significant weight in determining whether activities should be grouped together or separate. These factors are identified under Reg. Section 1.469-4(c)(2):

• The similarities and differences in the respective types of businesses
• The extent of common control between the businesses
• The respective geographical locations of each business
• The extent of common ownership between the businesses
• The interdependencies between the businesses

5. There is no bright line rule on grouping but the taxpayer must demonstrate that the grouping involved a reasonable method. Generally, a reasonable method for grouping would be similar economic endeavors or situations.

6. Under Rev. Proc. 2010 – 13, taxpayers are required to provide a report to the IRS of their groupings and re-groupings of activities. Likewise, any additions of specific activities within existing groupings must also be reported.

7. Generally, the taxpayer would file a written statement with the original return (including extensions) for the first tax year in which two or more trader businesses or rental activities are originally grouped together as a single activity. The statement must identify the names, addresses and tax identification numbers for the trade or business activities or rental activities being grouped as a single activity.

8. If it is determined that the original grouping was incorrect in a material nature, then the taxpayer must regroup the activities and provide a revised written statement the tax return. (See Reg. Section 1.469 – 4 (e) (2)). The revised statement must also contain declaration that the regroup activities constitute an appropriate economic unit for the measurement of gain or loss is under Section 469.

9. If the taxpayer either fails to identify the appropriate grouping or does not refile activity will be treated as a separate entity under Section 469.

G. Disposition

1. Passive Losses in the current tax year and those that are carryover from prior years are fully deductible on the disposition of a passive activity.

2. Section 469 (g) sets forth criteria that must be met before losses are deducted against nonpassive income. These include the following:

   a. The taxpayer disposes of the entire interest in the property.
   b. The transaction must not involve a related party. Related party is under Section 267 and 414.
   c. If there is a gain, the gain must be recognized
If the above are met, the overall net loss is fully deductible to the extent the taxpayer has basis.

4. If there is an overall net loss, the entire disposition is not reflected on Form 8582 and the entire loss is reflected on the appropriate schedules. If there are two dispositions, one with an overall net loss and one with an overall net gain, they should be netted.

5. It should be noted that a foreclosure is considered a disposition for which gain or loss is realized. As such a foreclosure qualifies as a disposition subject to the rules herein.

H. Real Estate Professionals

1. The general rule is the passive activity loss rules do not apply to a real estate professional. This would apply to real estate dealers and investors.

2. A real estate professional still must meet the definition of material participation after they meet the definition of a real estate professional.

3. In addition, they must satisfy certain eligibility to be a real estate professional and that includes the following (Reg. Section 1.469 – 9 (b)(6)).
   a. The individual must own at least one interest in rental real estate.
   b. More than 50% of the individual’s personal services during the tax year must be performed in real property trades or businesses in which the individual materially participates.
   c. The individual must perform more than 750 hours of service in those same trades or businesses (§469(c)(7)(B)).

4. Real Property Trades or Business consist of the following:
   • development, redevelopment, construction, reconstruction, acquisition, conversion;
   • rental;
   • operation, management, leasing; or
   • Brokerage trade or business (See Section 469(c)(7)(c)).

5. Mortgage Brokerage Services does not fall within the category of real property trade or business (See Guarino v. Comm., TCS 2016 – 12)

6. Both spouses are not required to demonstrate that they are real estate professionals under the provision. This is the case, so long as they file a joint return. This is not the case if they file a separate return, such as married filing separately. (See Goolsby v. Comm., TCM 2010-64)
7. Substantiation of Time

a. With respect to the evidence that may be used to establish hours of participation, the extent of an individual’s participation in an activity may be established by any reasonable means.

b. Time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means may include, but are not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries (See Reg. Sec. 1.469-5T(f)(4)).

Examples

**Makhlouf v. Comm., TCS 2017 – 1.** Taxpayers owned a primary residence for over 40 years. In July, 2009, they moved to a vacation home they owned and began renting out their primary residence. They executed two successive one-year leases by which they rented their primary residence to the same tenant. The taxpayers moved back into the primary residence. Three years later. During the tax year at issue. The taxpayer owned 20% of two apartment buildings in Egypt. The taxpayers visited Egypt twice in the tax year in question both visits. They stayed in the apartment at the rental location. On their tax return, they deducted rental losses of $70,000, claiming they were real estate professionals. The taxpayers argued that they were real estate professionals because they engaged in extensive management activities of both the US property and Egyptian property. However, they were unable to provide any evidence to support their argument. The couple submitted documents created after the tax year allegedly based on computer entries and a diary maintained by the wife. Hours shown on the spreadsheets were gaining in nature showing the taxpayer spent exactly the same number of hours on attacks that could easily be performed by one person or spending entire day’s alleged meetings with family members who co-owned the property. The taxpayers as result could not meet the 750 hour test to qualify as a real estate professional.

**Dini v. Comm., TCM 2017 – 34.** The taxpayers work at a dental practice four days a week in ships. The wife worked a morning shift and the husband the afternoon shift. The husband worked no more than 728 hours a year in the practice. The husband also had a real estate broker each activity and manage for rental properties to a couple owned together. The husband brokerage related activities included towards, listing searches, open houses, property viewings and Client meetings. The husband spent more than 1000 hours on the real estate and rental businesses during the three years at issue with the IRS. He provided support in the form of a log, and it was done on a contemporaneous basis. The taxpayer also provided witnesses that were found to be credible and corroborated the logs in testimony. The court ruled he was a real estate professional.

**Rapp v. Comm., TCS 2017 – 14.** The taxpayer was a real estate salesperson who owned and managed six rental properties. In 2009 and in 2010, he reported net rental losses. In addition, he was also a full-time employee, but not a 5% or more owner of a real estate development company. For the last nine months of 2010. He was a retail
sales manager for a real estate development company, but possessed no ownership interest. The taxpayer had no credible evidence to support that he spent 750 hours on his rental activities, and he failed to prove how much time he spent on his rental real estate activities. The court denied his attempt to attack the hours worked as a real estate salesperson since he was not a 5% or more owner. The taxpayer testified he was unaware of the tax laws, the requirement document, time spent on the real estate activities. The court indicated ignorance of his responsibilities to keep records of these activities did not relieve the taxpayer of the requirement to do so. The taxpayer also argued that the revenue generated from the rental real estate activities was higher than his wages for the years at issue qualify him as a real estate professional. The court noted that the real estate professional test is measured by hours, not by revenue. The taxpayer claimed that as a result, he should be able to deduct up to $25,000 of related passive activity losses as he actively participated in real estate activities. The court disagreed, indicating his modified AGI exceeded the hundred thousand dollars threshold for the phase out under Section 469.

8. As stated, after determining the taxpayers is a real estate professional, they must then prove that they materially participated in the real estate activity. This again is a time test but is more restrictive than the time test for real estate professional. An individual is considered as materially participating if they meet one of the seven task previously discussed. For a closely held corporation to satisfy more than 50% of the gross receipts of the corporation are derived from real property trade or businesses in which the corporation materially participates. This provision does not apply to limited partnerships or LLC finally asked partnerships. It also does not apply to trusts or estates.

TC No. 9

a. The Tax Court has determined that a trust that owned real estate properties and engaged in other real estate activities qualified for the Section 469(c)(7) exception for real estate professionals and thus wasn't subject to the passive activity loss (PAL) limitations. In so concluding, the Court found that services performed on behalf of a trust may be considered personal services performed by the trust.

b. The Trust is a complex residuary trust that owns rental real estate properties and is involved in other real estate business activities such as holding real estate and developing real estate. It was formed by Frank Aragona in '79, with him as grantor and trustee and with his five children as beneficiaries.

c. Frank Aragona died in 1981. He was succeeded as trustee by six trustees, his five children, one of whom acted as executive trustee, and one independent trustee. Although the trustees formally delegated their powers to the executive trustee, the trustees acted as a management board (Board) for Trust and made all major decisions regarding Trust's property. During 2005 and 2006, Board met every few months to discuss Trust's business.

d. Three of the children also worked full time for, and received wages from, Holiday Enterprises, LLC (Holiday), which is wholly owned by Trust and a disregarded entity for federal income tax purposes. Holiday managed most of
the trust's rental real estate properties and had a number of other employees in addition to the three children.

e. The Trust conducted some of its rental real estate activities directly, some through wholly owned entities, and the rest through entities in which it owned majority interests and in which Frank Aragona and a son owned minority interests. It conducted its real estate holding and real estate development operations through entities in which it owned majority or minority interests and in which Frank Aragona and the son owned minority interests.

f. During the 2005 and 2006 tax years, Trust incurred losses from its rental real estate properties which were reported on the trust's income tax returns, Forms 1041, "U.S. Income Tax Return for Estates and Trusts" and on Schedules E, "Supplemental Income and Loss." Some of the losses were reported as being associated with Holiday. On its returns, Trust treated its rental real estate activities, in which it engaged both directly and through its ownership interests in a number of entities, as non-passive activities. Accordingly, these losses contributed to Trust's net operating losses (NOLs), which Trust carried back to its 2003 and 2004 tax years. While reporting losses for its rental real estate activities, Trust also reported gains from its other (non-rental) real estate activities.

g. The issued a notice of deficiency determining that Trust's rental real estate activities were passive activities, which increased Trust's PALs for 2005 and 2006. This, in turn, resulted in a decrease in the allowable deductions from gross income for each of those years, which decreased the NOL carrybacks to the 2003 and 2004 tax years.

h. The issue presented in the case was whether Trust can qualify for the Section 469(c)(7) exception. The Service asserted that it can't, because "personal services" means work performed by an individual in connection with a trade or business. IRS cited certain legislative history underlying Section 469(c)(7), which states that the exception applies to individuals and closely held C corporations, as support.

i. The Court began its analysis by looking at the function of a trust. Specifically, an arrangement whereby trustees manage assets for the trust's beneficiaries. It concluded that if the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered "work performed by an individual in connection with a trade or business." (Reg. § 1.469-9(b)(4)) Accordingly, it concluded that a trust is capable of performing personal services and therefore can satisfy the Section 469(c)(7) exception.

j. The Court noted that, had Congress wanted to exclude trusts from the exception, it could have done so by explicitly limiting the exception to "any natural person," which is the language used in Section 469(i). It also found IRS's reliance on legislative history unconvincing, noting that the cited explanation didn't say that the exception applies only to individuals and closely held C corporations.
k. The Court then determined that Trust materially participated in its real estate operations and thus qualifies for the exception. The Court concluded that the activities of the trustees, including their activities performed as employees of Holiday, should be considered in determining whether Trust materially participated. Thus, the Court took into account the activities of all six trustees in their roles as trustees and as employees of Holiday (which constituted full-time participation in Trust's real estate operations). It also found that Trust's real estate operations were substantial and that the trustees handled practically no other businesses on behalf of Trust. Finally, the Court found that Trust's rental real estate activities weren't passive activities.

10. Aggregation of Real Property By a Real Estate Professional

a. Each interest of the taxpayer in rental real estate is to be considered as a separate activity, but a taxpayer may elect to treat all interests in real estate, including real estate held through pass-through entities, as one activity (See Section 469(c)(7)(A)).

b. The aggregation option permits the investor to meet the material participation test after cumulatively materially participating in all the real estate rentals. Without the aggregation option, the investor would be required to materially participate in each activity, making it more difficult to get around the passive loss limitations.

c. The election to treat all interests in rental real estate as a single rental real estate activity is binding for all future years unless there is a material change in a taxpayer’s facts and circumstances.

d. The taxpayer makes the election by filing a statement with his or her original income tax return. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to Section 469(c)(7)(A) (See Reg. Sec.1.469-9(g)).

**SAMPLE STATEMENT**

_Election to Aggregate All Rental Real Estate Interests. [taxpayer name, SSN], Form 1040, Tax Year Ending [mm/dd/yy]._

_Taxpayer hereby elects pursuant to Section 469(c)(7)(A) to treat all of his interests in rental real estate as one activity. Taxpayer is eligible to make the election since he meets the requirements of Section 469(c)(7)(B) and thus is a qualifying taxpayer for the tax year. “_

e. A taxpayer is eligible for an extension of time to file. The election. If the taxpayer represents on a statement, under penalty of perjury, that the taxpayer has met the following requirements:
• The only reason the aggregation election wasn’t made is because taxpayer did not file the required statement with his or her income tax return the first year the taxpayer became a real estate professional.

• The taxpayer filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective, and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years.

• The taxpayer timely filed each return that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within six months after its due date, excluding extensions.

• The taxpayer has reasonable cause for his or her failure to meet these requirements (See Reg. Section 1.469-9(g)).

f. The late election is associated with an amended return and the taxpayer must attach the following statement to the most recent year and mail the many return to the IRS Center where they filed the current return:

LATE ELECTION FILED PURSUANT TO REV. PROC. 2011-34.

1. “In accordance with §1.469-9(g)(3), the taxpayer hereby states that he (or she) is a qualifying real estate professional under IRC §469(c)(7), and elects under IRC Sec. 469(c)(7)(A) to treat all interests in real estate as a single rental real estate activity.”

2. This election is being filed late because . . . (e.g., the taxpayer relied on a tax professional who failed to advise him or her of the availability and benefits of this election).

3. This election applies to year _____ (i.e., the taxable year which the taxpayer wishes the late election to apply).

4. “Under penalties of perjury I (we) declare that I (we) have examined this election, including any accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete.”

5. Signed and dated by the taxpayer.

II. The Recharacterization Rules and Self-Rented Property

A. Reg. Sec. 1.469-2(f)(6) and 1.469-2(f)(9)(iii)

1. Taxpayer renting property to the taxpayer's own business will have to recharacterize income.

2. Gross rental income equal to net rental income (including any income from a sale) is recharacterized as active income if the property is rented to a trade or business activity
in which the taxpayer materially participates for the taxable year so long as the property is not property rented incidental to a development activity (See Reg. Sec.1.469-2(f)(6) and 1.469-2(f)(9)(iii)).

Example

Williams, Ca-5, 2/5/16, 2016 – 1 USTC_____. In 2009 and 2010 the taxpayer was the sole shareholder of an s corp. That owned commercial property and a c corp. That was his medical practice. The s corp. Leased to the medical C corp. commercial real estate which it used in its trade or business activities. The S corp. Had a net rental income of $53,285 and $48,657 in 2009 and 2010, respectively, from the rental of commercial real estate to the C corp. In those years. The taxpayer reported these amounts as passive income on Schedules E, supplemental income and loss, attached to their federal income tax returns for 2009 and 2010. They offset these amounts with passive losses from other S corps., partnerships, and personally owned rental properties. In the notice of deficiency, IRS reclassified the s corps. Rental income as nonpassive income pursuant to Reg. Section 1.469-2(f)(6) and disallowed the taxpayer’s passive losses that were claimed in excess of their adjusted passive income for tax years 2009 and 2010. Both the tax court and the fifth circuit court agreed with the IRS based on the language of section 469. The court did not address any intercompany payments between the entities.

3. The substantiation rules that were discussed earlier are important to meet with respect to self-rental property.

III. Like kind Exchanges

A. General Rule

1. Section 1031 governs like kind exchanges and the general indicates that no gain or loss will be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment (See Section 1031(a)(1)).

2. When cash or boot is associated with the exchange, gain is recognized to the extent of the cash or boot received. (See Section 1031 (b)).

3. Likewise, the relief of debt on the exchange is considered boot received. (See Reg. 1.1031(b) – 1).

4. The amount of boot received is decreased by the taxpayer’s expenses associated with the exchange.

B. Formula

1. The following formula is generally associated with determining gain recognized on a like kind exchange:
Money or Other Boot Received  
Plus: Net Mortgage Relief  
Less: Exchange Expenses  
Gain Recognized

2. The gain recognized cannot exceed the amount of the gain realized. Also, money or boot given cannot offset mortgage relief, but increase the mortgage does not offset the cash for the boot received.

Example

Moe exchanges land held as an investment with basis of $70,000 for other land with a FMV of $100,000 and a car with FMV of $2,000. The acquired land is to be held as an investment and the car is for personal use.

The realized gain is $100,000 + $2,000 - $30,000 = $32,000.

The recognized gain is $2,000.

3. The basis of property received in a non-taxable exchange is equal to the adjusted basis of the property exchanged increased by any gain and reduced by any boot received or loss recognized on the exchange.

Example

Moe exchanges land with a basis of $30,000 for $10,000 cash and equipment of $80,000 (FMV). The realized gain is $60,000 ($80,000+$10,000 - $30,000). $10,000 gain is recognized because the boot received is less than the gain realized. Basis in equipment is $30,000 ($30,000 basis of property exchanged - $10,000 boot received + $10,000 gain recognized.

The basis of the like-kind property received can also be computed by subtracting the basis of the new unrecognized gain from its FMV or by adding the unrecognized loss to its FMV.

In the above example, the $30,000 may be computed by subtracting the $50,000 of unrecognized gain from the $80,000 FMV.

C. Qualification for Like Kind Relief

1. Both the property given up in the property received by the taxpayer must be held for productive use in a trade or business or investment. (See Section 1031 (A) (1)). The code section does not define trade or business or investment. However, it can include buildings owned by a business, apartment buildings, plants, commercial buildings, machinery and equipment, trucks and other vehicles. So like kind exchange can involve both tangible and real property. Rental units are business property not investment property for purposes of a like kind exchange. In fact, rental property on a Schedule C, is not considered investment property, rather, it is considered business property. The concept of held for investment often refers to the appreciation in value of the property and can include exchanges in association with condominiums and raw lands. A personal residence, is not considered qualified use of property for purposes of a like kind exchange and historically did not fall within the category of like kind exchange.
treatment (See Moore v. Comm., TCM 2007 – 134). However, the IRS has provided under Rev. Proc.2008 – 16, a safe harbor to allow rental residents and vacation homes to qualify. In order for such property to qualify the property in question must have been rented out for at least 24 months immediately before the exchange and the replacement property rented at least 24 months immediately after the exchange.

2. In essence, the qualified property for qualified use is based on the use of the property given up and the property received in the taxpayer’s hands. The use of the property in the other party’s hands assisted exchange is not factored in to the assessment.

3. Under Letter Ruling 201-62-2008, a disregarded entity where the taxpayer owns 100% of the entity is allowed to participate in a like kind exchange of an divided interest in real property. This pertains only to the surface of the property.

4. Exchanges of properties between related parties are not considered like kind exchanges, especially if either party disposes of the property within two years. (See Section 1031(f)). As such, any gain resulting from the original exchange would be recognized in the year of the subsequent disposition. However, dispositions due to death or involuntary conversion are disregarded. Section 267 governs related parties, and such include the following:

   a. Brothers, sisters, spouse, ancestors, and lineal descendants;
   b. An individual and a corporation, which more than 50% of the outstanding stock is owned, directly or indirectly, by or for the individual;
   c. Two corporation members which are of the same controlled group;
   d. A grantor and a fiduciary of any trust;
   e. Two fiduciaries, if the grantor is the same for both trusts;
   f. A fiduciary and the beneficiary of that trust;
   g. Fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
   h. Fiduciary of a trust and a corporation, for which more than 50% of the outstanding stock is owned by either the trust or the grantor of the trust;
   i. A person and a Sec. 501 organization which is controlled directly or indirectly by the person or members of the person's family;
   j. A corporation and a partnership if the same person owns:
      (1). More than 50% of the outstanding stock of the corporation, and
      (2). More than 50% of the capital interest or the profits interest in the partnership;
   k. Two S corporations, if the same person owns more than 50% of the outstanding stock of each corporation; or
1. An S corporation and a C corporation, if the same persons own more than 50% of the outstanding stock of each corporation.

**Example**

ABC Corporation, is 100% owned by Moe and the corporation owns land with a basis of $200,000. Larry wanted to purchase the land for $900,000. Moe owned an office building with a basis of $750,000 and a FMV of $900,000. Instead of selling the land to Larry, ABC Corporation exchanged the land for Moe's office building in December, 2016. Two months later, Moe sells the land to Larry for $900,000. The exchange of the land for the office building is not a like-kind exchange because one of the related parties disposes of the property within two years of the exchange. In 2016, ABC's recognized gain on the exchange of the land is $700,000 ($900,000 - $200,000) and Linda's recognized gain on the exchange of the office building is $150,000 ($900,000 - $750,000). Because Moe's basis for the land is now $900,000, no gain is recognized on the sale of the land to Larry.

5. The holding period of like-kind property received in a nontaxable exchange includes the holding period of the property exchanged if the like-kind property surrendered is a capital asset or an asset that is Sec. 1231 property. In essence the holding period of the property exchanged carries over to the holding period of the like kind. The holding period for the boot property received begins the day after the date of the exchange.

6. The exchange period begins on transfer of the relinquished property and ends on the earlier of:
   a. 180 days later or
   b. The due date, including extensions, for the exchanger’s tax return for the year in which the transfer of the relinquished property occurs.

7. A replacement property is identified under the regulations, only if it is:
   a. Received by the exchanger before the end of the identification period, or
   b. Identified in a written agreement for the exchange of properties, or
   c. Designated as replacement property:
      i. In a written document
      ii. Signed by the exchanger
      iii. Hand delivered, mailed, telecopies, or otherwise sent before the end of the identification period
      iv. To a person involved in the exchange other than the exchanger or a disqualified person (See Reg. Sec. 1.1031(a)-3(c)).

**Example**

Under an exchange agreement, Mary transfers real estate to an intermediary on November 1, 2015. Several days later, the intermediary sells the replacement property and receives the cash from the sales proceeds, awaiting Mary's direction as to the purchase of replacement property in order to complete the exchange. On or before December 16, 2015. This is the 45 days after the transfer of the property to the intermediary. Mary must identify potential replacement properties in writing for the intermediary. Also, by April 15, 2016, the due date of Mary's Form 1040, the
exchange must be completed by transfer of the replacement property from the intermediary to Mary. However, if Mary's Form 1040 is extended, she receives the full 180 day time limit for replacement; this extends the replacement period to April 30, 2010.

8. The replacement property must be unambiguously described in the document or agreement by a legal description or street address.

D. Safe Harbors

1. The rules of actual and constructive receipt have been unclear as applied to like-kind exchanges. The regulations give four safe harbors, which can be used without risk of actual or constructive receipt. They are as follows:

2. The obligation of the exchanger’s transferee to complete the delayed exchange can be secured or guaranteed by:

   (a) A mortgage, deed of trust, or other security interest in property,

   (b) A standby letter of credit which satisfies all of the requirements of Reg. Sec.15A.453-1(b)(3)(iii) and which does not allow the taxpayer to draw on the letter of credit except on default of the transferee's obligation to transfer like-kind replacement property, or

   (c) A guarantee of a third party.

3. The obligation of the exchanger’s transferee to complete the delayed exchange may be secured by cash or a cash equivalent if held in a qualified escrow account or a qualified trust. The escrow holder or trustee must not be the exchanger or a disqualified person and the exchanger’s rights to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in escrow or trust must be limited. A person is a disqualified person if:

   (a) The person is an agent of the taxpayer at the time of the transaction, or

   (b) The person and the taxpayer have a relationship as defined under Sections 267(b) or 707(b) substituting 10% ownership for 50% ownership.

4. The exchanger’s use of a qualified intermediary who is the exchanger’s agent does not destroy an exchange, provided the exchanger’s rights to receive money or other property are limited. A qualified intermediary is a person who is not the exchanger or a disqualified person.

5. The exchanger can receive interest exchange provided his rights to receive interest and other economic benefits are limited.
Example

Julie owns Blackacre, which is worth $2,000,000 and has a tax basis of $500,000. Ron, unrelated wants to buy the parcel for development. However Julie insists on a like-kind exchange in order to avoid any current tax liability. Julie agrees to transfer Blackacre in exchange for Ron's promise to acquire and transfer suitable replacement property. In accordance with the agreement, Julie transfers Blackacre to Ron on December 1, 2015. Ron's promise is secured by $2,000,000 of cash placed in a qualified escrow account. Within the 45-day identification period, Julie sends Ron a signed document designating Greenacre, currently owned by Cindy and having a FMV of $1,600,000, as the replacement property.

On March 19, 2015, Ron buys Greenacre from Cindy for $1,600,000 cash. On the same day, he transfers Greenacre to Julie along with the $400,000 balance from the escrow account. Both the 45-day identification period rule and 180-day exchange period rule are met. The starting point for both periods is the December 1, 2015, closing date for the transfer of Blackacre to Ron. This qualifies as a deferred three-party exchange for Julie. On March 19, 2015, she recognizes a $400,000 taxable gain which is the lesser of $400,000 boot received or realized gain of $1.5 million. [See Reg. Sec.1.1031(k)-1(g)(8), Example 1 and Sec.1.1031(k)-1(j)(2)(vi), Example 1.]

The escrow arrangement must be a qualified escrow account, in order to avoid any risk of Julie being considered in constructive receipt of the entire $2,000,000 in 2015.

6. Often a qualified intermediary to conduct a four-party exchange.

7. Under the Sec.1031 regulations, the qualified intermediary is not considered the agent of the first party, even though the intermediary actually functions in that capacity.

8. The first party can transfer his property to the qualified intermediary and instruct the intermediary to sell the property for cash. The first party will not be considered in constructive receipt of the sales proceeds received by the qualified intermediary [Reg. Sec.1.1031(b)-2(a)]. Note that if the intermediary does not meet the qualified intermediary definition, the first party will have a constructive receipt problem.

9. Reg.Sec.1.1031(k)-1(g)(4) defines a qualified intermediary as a person who is not the taxpayer or a disqualified person and who, pursuant to a written exchange agreement with the taxpayer,

   • Acquires the original property from the taxpayer;
   • Transfers the taxpayer's property to the buyer;
   • Acquires replacement property from the seller; and
   • Transfers the replacement property to the taxpayer.

10. Disqualified persons are defined in Reg. Sec.1.1031(k)-1(k) and include certain parties automatically considered to be the taxpayer's agent (taxpayer's employee, attorney, etc.) and certain parties related to the taxpayer under IRC Sections 267(b) or 707(b), as modified.
11. In real estate transactions, qualified intermediaries may be unwilling to actually hold title to the original and replacement properties. Reg. Sec.1.1031(k)-1(g)(4)(v) says the qualified intermediary is deemed to accomplish the above title transfers via written assignments of contract rights. Actual title transfers are not necessary.

E. Reverse Exchanges

1. The deferred exchanges where the replacement property is identified and acquired after the property originally held by the taxpayer seeking Sec. 1031 exchange treatment has effectively been sold are often called Starker exchanges. Reverse Starker exchanges also exists.

2. In a reverse Starker exchange, the replacement property is acquired before the relinquished property is unloaded. The taxpayer has identified a property he wishes to acquire in a Sec. 1031 exchange but has not yet identified the property he will give up in exchange.

3. Rev. Proc. 2000-37 provides safe-harbor treatment whereby Section 1031 treatment will be deemed to apply for these types of exchanges that are conducted via "qualified exchange accommodation arrangements" (QEAs).

4. A QEAA is considered to exist if

   a. To facilitate the exchange, the legal titles to (or attributes of beneficial ownership in) both the replacement and relinquished properties are transferred to an "exchange accommodation holder" (as defined by Rev. Proc. 2000-37). Once the exchange accommodation holder acquires title to (or attributes of beneficial ownership in) the replacement and relinquished properties, the exchange accommodation holder must continue to hold the properties until the replacement property is ultimately transferred to the taxpayer and the relinquished property is ultimately transferred to its new owner.

   b. At the times the replacement property and the relinquished property are transferred to the exchange accommodation holder, the taxpayer (the party seeking Sec. 1031 treatment for the deal) must have a bona fide intent to exchange said properties in a transaction that qualifies for non-recognition treatment (in whole or in part) under IRC Sec. 1031.

   c. Within five business days after the date of transfer of title to (or attributes of beneficial ownership in) the replacement or relinquished property to the exchange accommodation holder, the taxpayer and the exchange accommodation holder must agree in writing that said property is being held to facilitate a Sec. 1031 exchange under Rev. Proc. 2000-37 and that the tax reporting rules established by Rev. Proc. 2000-37 will be respected by both parties.

   d. Within 45 days after the transfer of title to (or attributes of beneficial ownership in) the replacement property to the exchange accommodation holder, the taxpayer must identify the relinquished property in a manner consistent with Reg. Sec. 1.1031(k)-1(c). (Alternative or multiple properties may be identified.)
e. Within 180 days after the transfer of title to (or attributes of beneficial ownership in) the replacement property or relinquished property to the exchange accommodation holder, the replacement and relinquished properties must be transferred to their respective new owners.

f. The combined time period that the replacement and relinquished properties are held by the exchange accommodation holder cannot exceed 180 days.

5. The exchange accommodation holder fulfills the same role as a qualified intermediary in a four-party deferred exchange. In effect, the exchange accommodation holder is simply a beneficial owner) of the relinquished property and the replacement property. However, the exchange accommodation holder is treated for tax purposes as the legitimate legal owner solely in order for Sec. 1031 treatment to apply to the exchange.

6. The taxpayer and the exchange accommodation holder can engage in necessary transactions in order to affect the desired property exchange. This would include such things as:

- the taxpayer loaning the exchange accommodation holder the money needed to acquire the replacement property,
- the taxpayer can guarantee debt incurred by the exchange accommodation holder to do so
- the taxpayer can indemnify the exchange accommodation holder against costs incurred in the transaction
- the taxpayer can even lease the replacement property from the exchange accommodation holder
- the taxpayer can manage the replacement property and supervise improvements to it while it is held by the exchange accommodation holder. (See Section 4.03 of Rev. Proc. 2000-37.)

**Example**

**Estate of George H. Bartell, Jr. Deceased, et al. v. Comm., TC No. 5,(Aug. 10, 2016)).** In 1999, Bartell Drugs, a drugstore chain in Seattle, WA, and the surrounding area, entered into an agreement to purchase a property in Lynnwood, WA, from a third party. In anticipation of structuring an exchange transaction under Section 1031 to facilitate acquisition of Lynnwood, Bartell Drugs later assigned its rights in the purchase agreement to third-party exchange facilitator EPC Two and entered a further agreement with EPC.

That second agreement provided for EPC to purchase Lynnwood and for Bartell Drugs to have a right to acquire Lynnwood from EPC for a stated period and price. EPC so purchased Lynnwood on Aug. 1, 2000, with bank financing guaranteed by Bartell Drugs, acquiring title to Lynnwood at that time. Bartell Drugs then managed the construction of a drugstore on the Lynnwood property using proceeds from the aforementioned financing and, upon substantial completion of the construction in June 2001, leased the store from EPC from that time until title to Lynnwood was transferred from EPC to Bartell Drugs on Dec. 31, 2001.
In late 2001, Bartell Drugs contracted to sell its existing property in Everett, WA, to a fourth party. Bartell Drugs next entered an exchange agreement with intermediary Section 1031 Services (SS) and assigned to SS its rights under the sale agreement and under the earlier agreement with EPC. SS sold the Everett property, applied the proceeds of that sale to the acquisition of Lynnwood, and had the title to Lynnwood transferred to Bartell Drugs on Dec. 31, 2001. The Tax Court held that Bartell Drug's disposition of the Everett property and acquisition of the Lynnwood property in 2001 qualifies for non-recognition treatment pursuant to §1031 as a like-kind exchange, because EPC is treated as the owner of Lynnwood during the period it held title to the property.

IV. Real Estate Dealer

A. Definition and Standard

1. There is no definition in the Code and Regs as to what constitutes a real estate dealer. However, a significant line of court cases has held that those who hold property out held primarily for sale to customers in the ordinary course of business are dealers.

2. The determination of an investor vs. dealer is made on a property-by-property basis and not an individual-by-individual basis.

3. The courts have held that a taxpayer may hold lands primarily for sale to customers in the ordinary course of his trade or business and, at the same time, hold other lands for investment” (See Stewart Mathews v. Comm., (63-1 USTC ¶9360) 315 F.2d 1963, affg. TCM 1961-213).

4. The courts have traditionally used the following factors (Winthrop, Ada Belle v. Tomlinson, (CA-5) 69-2 USTC ¶9686, 417 F2d 905)):

   • The reason and purpose the property was acquired and/or disposed;
   • The length of time the property was held;
   • The number and frequency of sales, usually annually;
   • The continuity of sales or sales-related activity over a period of time;
   • Overall reluctance to sell the property;
   • The substantiality of the gain obtained on the sale;
   • The extent to which the taxpayer or his or her agents engaged in sales activities by developing or improving the property, soliciting customers, or advertising;
   • The substantiality of sales when compared with other sources of the taxpayer’s income; and
   • The desire to liquidate unexpectedly obtained land holdings (such as by inheritance).

5. Real estate sales by dealers are considered sales of inventory and are taxed as ordinary income tax rates. Such sales are also subject to self-employment tax.

6. A broker or real estate agent can be an investor. There must be a distinction
however. Specifically, a dealer in real estate must be distinguished from a real estate broker a real estate agent. The dealer has ownership interest in property, whereas a real estate broker agent brings parties together from a buying selling perspective. (See Wilford v Comm., TCM, 1992 – 430)

7. An intent to develop real property is not enough to create an ordinary loss and does not make the taxpayer a real estate dealer. (See Evans v. Comm. TCM 2016 – 7)

Example

A taxpayer has worked in the field of real-estate construction and development since he graduated from college in 1973. For most of that period, he worked for firms that oversaw the construction of large high-rise buildings. The taxpayer also purchased for himself residential real-estate properties (three properties in the four years prior to the year of audit) that he hoped to tear down existing buildings and construct single or multi-unit residences for sale or rent. The taxpayer purchased the property known as Newport Beach in 2006 for $1,400,000. The Newport Beach property was a plot of land which included an unoccupied house and garage. He intended to tear down the existing buildings and build a two-unit house for sale or rent. In 2008, he defaulted on a $250,000 note secured by the Newport Beach property. The lender foreclosed and sold the property for $556,000. On the tax return for 2008, he reported an inventory loss of $1,041,330 from the foreclosure sale. The $1,041,330 loss was equal to the $1,597,330 they reported as their basis in the Newport Beach property minus the $556,000 that they reported as sale proceeds. At the time he purchased the Newport Beach property, his primary intention was to tear down existing structures and develop and sell the property. However, even if he acquired the Newport Beach property with the intention of developing it, this does not mean that he was in the business of property development and sale. If the facts indicate that the taxpayer engages in regular (rather than isolated or sporadic) sales of property support a finding that he or she is engaged in a trade or business. (See Pool v. Comm., 251 F.2d 233, 237 (9th Cir. 1957), aff’g TCM 1956-64.) The court found that Evans’s testimony about other properties he may have acquired for development and sale was too vague to be reliable. The showed that Evans’s property sales were sporadic, not frequent and continuous. The court’s analysis of the facts lead it to conclude that Evans’s personal real-estate-development activities did not constitute a trade or business for purposes of Section 1221(a)(1) and that, therefore, the Newport Beach property was a capital asset. As such, he lost a significant deduction.

B. Downside to Being a Dealer

1. There are some disadvantages to being a real estate dealer. These include the following:

- May not use the like-kind exchange provisions because they hold real property as stock-in-trade (inventory) and not for productive use in business or for investment (See Section 1031(a)(2)).
- May not use the installment sales method of accounting for gains and losses on real estate sales.
• May not use the reduced capital gain tax rates applicable for sales of real estate by investors.
• Real estate sales by dealers are considered sales of inventory and are taxed at the ordinary income tax rates. This also includes being subject to self-employment tax.

3. Section 1234A. Gain or loss is attributable to the cancellation, expiration, lapse or termination of a right or obligation with respect to property which is an acquisition or would be an acquisition is considered a capital assets in the hands of the taxpayer or a Section 1256 contract which is also a capital asset in the hands of the taxpayer. Any proceeds received from the cancellation would be treated as an association sale of a capital asset.

2. This would apply to real estate dealers and investors. However, the following example goes counter to this section of the code.

Example

Leslie LLC v. Comm., USTC No. 8 (September, 7, 2016). In 2005, the LLC purchased a hotel in Tampa, Florida. In July 2006, the LLC entered into to an agreement to sell the hotel for $39 million. The LLC entered into an agreement as such. The LLC received deposits of $9.7 million from the potential buyer in connection with the agreement. The deposits would be applied against the purchase price, at closing. The buyer defaults it on the agreement in 2008 and forfeited $9.7 million. The LLC reported the deposits as net long-term capital gains, arguing that Section 1234A was designed to ensure that taxpayers receive the same tax character of gain or loss, irrespective of whether the property is sold. As such, it is inconsistent to treat termination payments on a contract as ordinary income with the sale of the underlying property would be treated as capital gains. The IRS disagreed, arguing that the code section refers to property that is a capital asset in the hands, the taxpayer and that section 1231, property is explicitly excluded from the definition of capital assets. The court found that the LLC’s argument and thus the deposits were ruled as ordinary income, not long-term capital gains. This case remains on appeal.

V. Prepaid Rent

A. General Rule

1. The rules under Reg. Section 1.467 – 1 (c)(3)(ii) states that a rental agreement, has prepaid rent the cumulative amount of the rent payable as of the close of the tax year exceeds the cumulative amount of rent allocated as of the close of the succeeding calendar year.

Example

Bubba and Bubbet enter into a rental agreement that provides for a 10-year lease of personal property, beginning on January 1, 2017, and ending on December 31, 2026. The rental agreement provides for accruals of rent of $10,000 during each month of the lease term. $120,000 is allocated to each calendar year. The rental agreement provides
for a $1,200,000 payment on December 31, 2017. Despite the fact that the agreement
does not have increasing or decreasing rent, it provides prepaid rent because the
cumulative amount of rent payable as of the close of a calendar year exceeds the
cumulative amount of rent allocated as of the close of the succeeding calendar year.
The cumulative amount of rent payable as of the close of 2017 is $1,200,000. This
exceeds the cumulative amount of rent allocated as of the close of 2017 the succeeding
calendar year ($240,000). As such, considered a prepaid rental agreement.

VI. Construction Tax Issues

A. Section 460: Introduction

1. Section 460 of the Internal Revenue Code provides rules for determining whether a
contract for the construction of property is a long-term contract and what activities
must be accounted for as a single long-term contract.

2. A contract not completed in the contracting year is a long-term construction
contract if it involves the building, construction, reconstruction, or rehabilitation of
real property; the installation of an integral component to real property; or the
improvement of real property (collectively referred to as construction).

3. Real property means land, buildings, and inherently permanent structures, as
defined in Reg. Sec. 1.263A-8(c)(3), such as roadways, dams, and bridges. Real
property does not include vessels, offshore drilling platforms, or unsevered natural
products of land.

4. An integral component to real property includes property not produced at the site of
the real property but intended to be permanently affixed to the real property, such as
elevators and central heating and cooling systems.

5. A taxpayer generally must determine the income from a long-term contract using
the percentage-of-completion method described in Reg. Sec. 1.460-4(b) The cost
allocation rules associated with the percentage of completion method are described
in Reg. Sec. 1.460-5(b) or (c). In addition, a taxpayer generally must apply the
look-back method under Reg. Sec. 1.460-6 to determine the amount of interest
owed.

6. The requirement to use the percentage of completion method does not apply to any
exempt construction contract described in Reg. Sec. 1.460-3(b). Construction
contractors that are large homebuilders described in Reg. Sec. 1.460-5(d)(3) must
capitalize costs under section 263A.

7. All other exempt construction contractors must account for the cost of construction
using the appropriate rules contained in other sections of the Internal Revenue Code
or regulations.

8. The requirement to use the percentage of completion method applies only to a
portion of a contract described in Reg. Sec. 1.460-2(d) or residential construction
contract described in Reg. Sec. 1.460-3(c).
9. A taxpayer generally may determine the income from a qualified ship contract or residential construction contract using the percentage-of-completion/capitalized-cost method described in Reg. Sec. 1.460-4(e), but must use a cost allocation method described in Reg. Sec. 1.460-5(b) for the entire contract.

10. Note that a contract is not a construction contract under section 460 if the contract includes the provision of land by the taxpayer and the estimated total allocable contract costs attributable to the construction activities are less than 10 percent of the contract's total contract price, as defined in Reg. Sec. 1.460-4(b)(4)(i).

11. In determining when a contract is entered into and completed, the taxpayer must consider all relevant allocable contract costs incurred and activities performed by itself, by related parties, and by the customer. In addition, to determine whether a contract is completed in the contracting year, the taxpayer may not consider when it expects to complete the contract.

12. Change orders do not affect the determination of when it is completed. A taxpayer's contract is completed upon the earlier of:

   a. The use of the subject matter of the contract by the customer for its intended purpose and at least 95 percent of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer; or

   b. Final completion and acceptance of the subject matter of the contract.

13. To determine whether final completion and acceptance of the subject matter of a contract have occurred, a taxpayer must consider all relevant facts and circumstances. Nevertheless, a taxpayer may not delay the completion of a contract for the principal purpose of deferring federal income tax.

14. Note that final completion and acceptance is determined without regard to any contractual term that provides for additional compensation that is contingent on the successful performance of the subject matter of the contract.

15. A taxpayer must account for all contingent compensation that is not includible in total contract price under Reg. Sec. 1.460-4(b)(4)(i), or in gross contract price under Reg. Sec. 1.460-4(d)(3), using a permissible method of accounting.

16. For application of the look-back method for contracts accounted for using the percentage of completion method. (See Reg. Reg. Sec. 1.460-6(c)(1)(ii) and (2)(vi)). Likewise, final completion and acceptance is determined without regard to whether a dispute exists at the time the taxpayer tenders the subject matter of the contract to the customer.

17. Long-term contract methods of accounting apply only to the gross receipts and costs attributable to long-term contract activities. Gross receipts and costs attributable to long-term contract activities means amounts included in total contract price or gross contract price, whichever is applicable, as determined under Reg. Sec. 1.460-4, and costs allocable to the contract, as determined under Reg. Sec. 1.460-5.
B. Exempt Contracts Under Reg. Reg. Sec. 1.460-3

1. The percentage of completion method and the cost allocation rules described in Reg. Sec. 1.460-5(b) or (c) do not apply to the following types of construction contracts:

   a. Home construction contract; and

   b. Other construction contract that a taxpayer estimates (when entering into the contract) will be completed within 2 years of the contract commencement date, provided the taxpayer satisfies the $10,000,000 gross receipts test.

2. A contract is a home construction contract if a taxpayer, including a subcontractor working for a general contractor, reasonably expects to attribute 80 percent or more of the estimated total allocable contract costs (including the cost of land, materials, and services), determined as of the close of the contracting year, to the construction of:

   a. Dwelling units, as defined in section 168(e)(2)(A)(ii)(I), contained in buildings containing 4 or fewer dwelling units (including buildings with 4 or fewer dwelling units that also have commercial units); and

   b. Improvements to real property directly related to, and located at the site of, the dwelling units.

3. The $10,000,000 gross receipts test is satisfied if a taxpayer's (or predecessor's) average annual gross receipts for the 3 taxable years preceding the contracting year do not exceed $10,000,000, as determined using the principles of the gross receipts test for small resellers under Reg. Sec. 1.263A-3(b).

4. The taxpayer is not required to aggregate the gross receipts of persons treated as a single employer solely under section 414(m) and any regulations prescribed under section 414.

5. A taxpayer must aggregate a proportionate share of the construction-related gross receipts of any person that has a five- percent or greater interest in the taxpayer. In addition, a taxpayer must aggregate a proportionate share of the construction-related gross receipts of any person in which the taxpayer has a five- percent or greater interest.

6. For this purpose, a taxpayer must determine ownership interests as of the first day of the taxpayer's contracting year and must include indirect interests in any corporation, partnership, estate, trust, or sole proprietorship according to principles similar to the constructive ownership rules under sections 1563(e), (f)(2), and (f)(3)(A).

7. However, a taxpayer is not required to aggregate under this paragraph (b)(3)(iii) any construction-related gross receipts required to be aggregated under paragraph (b)(3)(i) of this section.
8. A taxpayer may determine the income from a long-term construction contract that is a residential construction contract using either the percentage of completion method or the percentage-of-completion/capitalized-cost method of accounting described in Reg. Sec. 1.460-4(e).

9. A residential construction contract is a home construction contract except that the building or buildings being constructed contain more than 4 dwelling units.

C. Percentage-of-completion method

1. The taxpayer generally must include in income the portion of the total contract price that corresponds to the percentage of the entire contract that the taxpayer has completed during the taxable year.

2. The percentage of completion must be determined by comparing allocable contract costs incurred with estimated total allocable contract costs.

3. Thus, the taxpayer includes a portion of the total contract price in gross income as the taxpayer incurs allocable contract costs.

4. The following steps are used in determining the income to include from a long-term contract:

:Step 1: Compute the completion factor for the contract.

Cumulative allocable contract costs incurred for the taxable year

Estimated total allocable contract costs under the contract

Step 2: Compute the amount of cumulative gross receipts from the contract

Completion Factor x Total Contract Price

Step 3: Compute the amount of current-year gross receipts

(Cumulative gross receipts for the current taxable year - Cumulative gross receipts for the immediately preceding taxable year)

5. Consider both the current-year gross receipts and the allocable contract costs incurred during the current year into account in computing taxable income.

6. If a taxpayer has not included the total contract price in gross income by the completion year, as defined in Reg. Sec. 1.460-1(b)(6), the taxpayer must include the remaining portion of the total contract price in gross income for the taxable year following the completion year.

7. The Total Contract Price refers to the amount that a taxpayer reasonably expects to receive under a long-term contract, including holdbacks, retainages, and cost reimbursements.
8. Note that contingent rights such as a bonus, award, incentive payment, and amount in dispute, is included in total contract price as soon as the taxpayer can reasonably expect that the amount will be earned, even if the all events test has not yet been met. This method of inclusion is the same in the event that there is a dispute with the contract.

9. Total contract price does not include compensation that might be earned under any other agreement that the taxpayer expects to obtain from the same customer such as the exercise of an option.

10. The Total Contract Price includes an allocable share of the gross receipts attributable to a non-long-term contract activity, as defined in Reg. Sec. 1.460-1(d)(2), provided that the activity is incident to or necessary for the construction of the subject matter.

11. As such, the contract price would include amounts reimbursed for independent research and development expenses (as defined in Reg. Sec. 1.460-1(b)(9)), bidding costs as defined in section 460(d).

12. A taxpayer must use a cost allocation method permitted under either Reg. Sec. 1.460-5(b) or (c) to determine the amount of cumulative allocable contract costs and estimated total allocable contract costs that are used to determine a contract's completion factor.

13. A taxpayer must allocate to each long-term contract subject to the percentage of completion method all direct costs and certain indirect costs properly allocable to the long-term contract.

14. Costs are all costs that directly benefit or are incurred by reason of the performance of the long-term contract.

15. In regards to the cost allocation method for contracts subject to percentage of completion method, the following special rules apply.

a. The costs of direct materials must be allocated to a long-term contract.

b. The costs of a component or subassembly produced by the taxpayer must be allocated to a long-term contract as the taxpayer incurs costs to produce the component if the taxpayer reasonably expects to incorporate the component into the subject matter of the contract.

c. A taxpayer must allocate any identified costs to a cost-plus long-term contract or federal long-term contract. Identified cost means any cost, including a charge representing the time-value of money, identified by the taxpayer or related person as being attributable to the taxpayer's cost-plus long-term contract or federal long-term contract under the terms of the contract itself or under federal, state, or local law or regulation.

d. If property produced under a long-term contract is designated property, a taxpayer must allocate interest incurred during the production period.
16. Allocable contract costs include a reimbursable cost that is allocable to the contract. To determine a contract's completion factor for a taxable year, a taxpayer must take into account the cumulative allocable contract costs that have been incurred, as defined in Reg. Sec. 1.460-1(b)(8), through the end of the taxable year.

17. The regulations under Reg. Reg. Sec. 1.460-5 outline the methods of allocating costs to long-term contracts accounted for under the percentage-of-completion method, the completed-contract method, or the percentage-of-completion/capitalized-cost method. In general, a taxpayer must allocate costs to each long-term contract subject to the percentage of completion method in the same manner that direct and indirect costs are capitalized to property produced by a taxpayer under Reg. Sec. 1.263A-1(e) through (h).

18. A taxpayer must allocate to each long-term contract all direct costs and certain indirect costs properly allocable to the long-term contract.

19. The costs of direct materials must be allocated to a long-term contract when dedicated to the contract under principles similar to those in Reg. Sec. 1.263A-11(b)(2).

20. A taxpayer dedicates direct materials by associating them with a specific contract, including by purchase order, entry on books and records, or shipping instructions.


a. If an administrative, service, or support function is performed solely at the jobsite for a specific long-term contract, the taxpayer may allocate all the direct and indirect costs of that administrative, service, or support function to that long-term contract.

b. Similarly, if an administrative, service, or support function is performed at the jobsite solely for the taxpayer's long-term contract activities, the taxpayer may allocate all the direct and indirect costs of that administrative, service, or support function among all the long-term contracts performed at that jobsite. For this purpose, jobsite means a production plant or a construction site.

D. Simplified cost-to-cost method for contracts subject to the Percentage of Completion Method

1. A taxpayer may elect to use the simplified cost-to-cost method, which is authorized under section 460(b)(3)(A), to allocate costs to a long-term contract subject to the percentage of completion method.

2. Under the simplified cost-to-cost method, a taxpayer determines a contract's completion factor based upon only direct material costs; direct labor costs; and depreciation, amortization, and cost recovery allowances on equipment and
facilities directly used to manufacture or construct the subject matter of the contract.

2. For this purpose, the costs associated with any manufacturing or construction activities performed by a subcontractor are considered either direct material or direct labor costs, as appropriate, and therefore must be allocated to the contract under the simplified cost-to-cost method.

3. An electing taxpayer must use the simplified cost-to-cost method to apply the look-back method under Reg. Sec. 1.460-6 and to determine alternative minimum taxable income under Reg. Sec. 1.460-4(f).

4. The election is made on the tax return in the year the method is adopted. This election is a method of accounting and, thus, applies to all long-term contracts entered into during and after the taxable year of the election.

5. This election is not available if a taxpayer does not use the percentage of completion method or the 10-percent method described in Reg. Sec. 1.460-4(b)(6).

Example

C, whose taxable year ends December 31, determines the income from long-term contracts using the Percentage of Completion Method. During 2014, C agrees to manufacture for the customer, B, a unique item for a total contract price of $1,000,000. Under C's contract, B is entitled to retain 10 percent of the total contract price until it accepts the item. By the end of 2014, C has incurred $200,000 of allocable contract costs and estimates that the total allocable contract costs will be $800,000. By the end of 2015, C has incurred $600,000 of allocable contract costs and estimates that the total allocable contract costs will be $900,000. After completing the contract, C determines that the actual cost to manufacture the item was $750,000. For each of the taxable years, C's income from the contract is computed as follows:

<table>
<thead>
<tr>
<th>Taxable Year</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) Cumulative incurred costs</td>
<td>$200,000</td>
<td>$600,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>(B) Estimated total costs</td>
<td>800,000</td>
<td>900,000</td>
<td>750,000</td>
</tr>
<tr>
<td>(C) Completion factor:</td>
<td>25.00%</td>
<td>66.67%</td>
<td>100.00%</td>
</tr>
<tr>
<td>(D) Total contract price</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>(E) Cumulative gross receipts:</td>
<td>250,000</td>
<td>666,667</td>
<td>1,000,000</td>
</tr>
<tr>
<td>(F) Cumulative gross receipts</td>
<td>(0)</td>
<td>(250,000)</td>
<td>(666,667) (prior year)</td>
</tr>
<tr>
<td>(G) Current-year gross</td>
<td>250,000</td>
<td>416,667</td>
<td>333,333</td>
</tr>
<tr>
<td>(H) Cumulative incurred costs</td>
<td>200,000</td>
<td>600,000</td>
<td>750,000</td>
</tr>
<tr>
<td>(I) Cumulative incurred costs</td>
<td>(0)</td>
<td>(200,000)</td>
<td>(600,000) (prior year)</td>
</tr>
<tr>
<td>(J) Current-year costs</td>
<td>$200,000</td>
<td>$400,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>(K) Gross income: (G)-(J)</td>
<td>$50,000</td>
<td>$16,667</td>
<td>$183,333</td>
</tr>
</tbody>
</table>
**E. Ten Percent Method**

1. The taxpayer may elect to use the 10-percent method under section 460(b)(5). Under the 10-percent method, a taxpayer does not include in gross income any amount related to allocable contract costs until the taxable year in which the taxpayer has incurred at least 10 percent of the estimated total allocable contract costs. A taxpayer must treat costs incurred before the 10-percent year as pre-contracting costs.

2. A taxpayer makes an election by using the 10-percent method for all long-term contracts entered into during the taxable year of the election on its original federal income tax return for the election year. The election is not available if a taxpayer uses the simplified cost-to-cost method.

**Example**

Carl has a taxable year of December 31 and uses the percentage of completion method. In November 2014, he agrees to manufacture a unique item for $1,000,000 and estimates that the total allocable contract costs will be $600,000. By December 31, 2014, he has received $50,000 in progress payments and incurred $40,000 of costs. Carl elects to use the 10 percent method effective for 2014. During 2015, he receives $500,000 in progress payments and incurs $260,000 of costs. In 2016, he incurs an additional $300,000 of costs. He finishes in 2016 and receives the final $450,000 payment. For each of the taxable years, C's income from the contract is computed as follows:

<table>
<thead>
<tr>
<th>Taxable Year</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) Cumulative incurred costs</td>
<td>$40,000</td>
<td>$300,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>(B) Estimated total costs</td>
<td>600,000</td>
<td>600,000</td>
<td>600,000</td>
</tr>
<tr>
<td>(C) Completion factor</td>
<td>6.67%</td>
<td>50.00%</td>
<td>100.00%</td>
</tr>
<tr>
<td>(D) Total contract price</td>
<td>1,000,000</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>(E) Cumulative gross receipts:</td>
<td>0</td>
<td>500,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>(F) Cumulative gross receipts</td>
<td>(0)</td>
<td>(0)</td>
<td>(500,000)</td>
</tr>
<tr>
<td>(G) Current-year gross rec 500,000</td>
<td>0</td>
<td>500,000</td>
<td></td>
</tr>
<tr>
<td>(H) Cumulative incurred costs</td>
<td>0</td>
<td>300,000</td>
<td>600,000</td>
</tr>
<tr>
<td>(I) Cumulative incurred costs</td>
<td>(0)</td>
<td>(0)</td>
<td>(300,000)</td>
</tr>
<tr>
<td>(J) Current-year costs</td>
<td>0</td>
<td>300,000</td>
<td>300,000</td>
</tr>
<tr>
<td>(K) Gross income: (G) -(J)</td>
<td>$0</td>
<td>$200,000</td>
<td>$200,000</td>
</tr>
</tbody>
</table>
F. Completed-contract method

1. Under the completed contract method, a taxpayer must take into account in the contract's completion year, as defined in Reg. Sec. 1.460-1(b)(6), the gross contract price and all allocable contract costs incurred by the completion year.

2. A taxpayer may not treat the cost of any materials and supplies that are allocated to a contract, but actually remain on hand when the contract is completed, as an allocable contract cost.

3. Like the percentage of completion method, the gross contract price under the completed contract method includes all amounts that a taxpayer is entitled by law or contract to receive, whether or not the amounts are due or have been paid.

4. It also includes all bonuses, awards, and incentive payments, such as a bonus for meeting an early completion date, to the extent the all events test is satisfied.

5. In the event that there is a dispute by the customer under the terms of the contract and the dispute is either a claim for a reduction in price or additional work and the taxpayer is assured of either a profit or a loss on a long-term contract regardless of the outcome, the gross contract price is reduced by the amount reasonably in dispute. It is take into accounting in the year of completion.

6. If the taxpayer is assured a profit on the contract, all allocable contract costs incurred by the end of the completion year are taken into account in that year. If the taxpayer is assured a loss on the contract, all allocable contract costs incurred by the end of the completion year, reduced by the amount reasonably in dispute, are taken into account in the completion year.

7. If the amount reasonably in dispute is such that the taxpayer cannot determine whether there is a profit or loss, the gross contract price or allocable contract costs are not taken into account in the completion year. Rather they are taken into account in the period the dispute is resolved.

Example

In 2014, Carl, whose taxable year ends December 31, uses the completed contract method to account for exempt construction contracts. He enters into a contract to construct a bridge for Bud with a $1,000,000 gross contract price. The bridge is completed in 2015 at a cost of $950,000. Bud insists that Carl repaint several girders or reduce the contract price. The amount reasonably in dispute is $10,000. In 2016, they resolve their dispute and the girders are repainted at a cost of $6,000. The contract price is not to be reduced. Carl was assured a profit of $40,000 ($1,000,000 – $10,000 – $950,000). He must take this $40,000 into account in 2015. In 2016, he will earn an additional $4,000 profit ($1,000,000 – $956,000 – $40,000) from the contract and must take into account an additional $10,000 of gross contract price and $6,000 of additional contract costs.
G. Cost allocation rules for exempt construction contracts reported using the Completed Contract Method

1. For exempt construction contracts reported using this method, the taxpayer must allocate to each exempt construction contract all direct costs as defined in Reg. Sec. 1.263A-1(e)(2)(i) and all indirect costs either as provided in Reg. Sec. 1.263A-1(e)(3). The following costs are indirect costs that must be allocated to an exempt construction contract:

- Repair of equipment or facilities;
- Maintenance of equipment or facilities;
- Utilities allocable to equipment or facilities;
- Rent of equipment or facilities;
- Indirect labor and contract supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay;
- Indirect materials and supplies;
- Noncapitalized tools and equipment;
- Quality control and inspection;
- Taxes to the extent attributable to labor, materials, supplies, equipment, or facilities;
- Depreciation, amortization, and cost-recovery allowances reported for the taxable year for financial purposes on equipment and facilities;
- Cost depletion;
- Administrative costs other than the cost of selling or any return on capital;
- Compensation paid to officers other than for incidental or occasional services;
- Insurance, such as liability insurance on machinery and equipment; and
- Interest.

2. A taxpayer allocating costs under this paragraph (d)(2) is not required to allocate the following indirect costs to an exempt construction contract:

- Marketing and selling expenses, including bidding expenses;
- Advertising expenses;
- Other distribution expenses;
- General and administrative expenses attributable to the performance of services that benefit the taxpayer's activities as a whole (e.g., payroll expenses, legal and accounting expenses);
- Research and experimental expenses;
- Losses under section 165 and the regulations thereunder;
- Percentage of depletion in excess of cost depletion;
- Depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle and depreciation, amortization and cost recovery allowances in excess of depreciation, amortization, and cost recovery allowances reported by the taxpayer in the taxpayer's financial reports;
- Income taxes attributable to income received from long-term contracts;
- Contributions paid to or under a stock bonus, pension, profit-sharing, or annuity plan or other plan deferring the receipt of compensation whether or not the plan
qualifies under section 401(a), and other employee benefit expenses paid or accrued on behalf of labor, to the extent the contributions or expenses are otherwise allowable as deductions under chapter 1 of the Internal Revenue Code;

- Cost attributable to strikes, rework labor, scrap and spoilage; and
- Compensation paid to officers attributable to the performance of services that benefit the taxpayer's activities as a whole.

3. A taxpayer must capitalize the costs of home construction contracts under section 263A and the regulations thereunder, unless the contract will be completed within two years of the contract commencement date and the taxpayer satisfies the $10,000,000 gross receipts test described in Reg. Sec. 1.460-3(b)(3).

H. Percentage-of-completion/capitalized-cost method.

1. Under this hybrid method, their taxpayer must determine the income from a long-term contract using the method for the remaining percentage of the contract. For residential construction contracts, the applicable percentage is 70 percent, and the remaining percentage is 30 percent.

I. Reg. Sec. 1.460-6 Look-Back Method

1. With respect to income from any long-term contract reported under the percentage of completion method, a taxpayer is required to pay or is entitled to receive interest under section 460(b) on the amount of tax liability that is deferred or accelerated as a result of overestimating or underestimating total contract price or contract costs.

2. Under this look-back method, taxpayers are required to pay interest for any deferral of tax liability resulting from the underestimation of the total contract price or the overestimation of total contract costs. If the total contract price is overestimated or the total contract costs are underestimated, taxpayers are entitled to receive interest for any resulting acceleration of tax liability.

3. The computation of the amount of deferred or accelerated tax liability under the look-back method is hypothetical. It does not result in an adjustment to the taxpayer's tax liability as originally reported, as reported on an amended return, or as adjusted on examination.

4. The look-back method generally does not apply to the regular taxable income from any long-term construction contract within the meaning of section 460(e)(4) that:

5. Is a home construction contract within the meaning of section 460(e)(1)(A), or

a. Is not a home construction contract but is estimated to be completed within a 2-year period by a taxpayer whose average annual gross receipts for the 3 tax years preceding the tax year the contract is entered into do not exceed $10,000,000 (as provided in section 460(e)(1)(B))

b. The look-back method does not apply to any long-term contract that:
i. Is completed within 2 years of the contract commencement date, and

ii. Has a gross contract price (as of the completion of the contract) that does not exceed the lesser of $1,000,000 or 1 percent of the average annual gross receipts of the taxpayer for the 3 tax years preceding the tax year in which the contract is completed.

The amount of interest credited to a taxpayer under the look-back method is computed in three steps.

**Step 1: Hypothetical reallocation of income among prior tax years**

The first step is to hypothetically reapply the percentage of completion method to all long-term contracts that are completed or adjusted in the current year (the "filing year"), using the actual, rather than estimated, total contract price and contract costs. The taxpayer determines the amount of taxable income and alternative minimum taxable income that would have been reported for each year prior to the filing year that is affected by contracts completed in the filing year if the actual total contract price and costs had been used in applying the percentage of completion method to these contracts, and to any other contracts completed or adjusted in a year preceding the filing year.

A taxpayer using the 10-percent method must also use the 10-percent method in applying the look-back method, using actual total contract costs to determine the 10-percent year.

**Example**

Ace elected to use the 10-percent method for reporting income under the percentage of completion method. Ace entered into a contract for a fixed price of $1,000. Ace incurred allocable contract costs of $80 and estimated that it would incur a total of $900 for the entire contract. Since $80 is less than 10 percent of total estimated contract costs, no revenue was reported and deferred $80 of costs incurred. In yr2, Ace incurred an additional $620 of contract costs, and completed the contract. Accordingly, in its yr2 return, Ace reported the entire contract price of $1,000 and deducted the $620 and the $80 of costs incurred in yr1. Under section 460(b)(5), the 10-percent method applies both for reporting contract income and the look-back method. Under the look-back method, since the costs incurred in yr1 exceed 10 percent of the actual total contract costs ($700), Ace is required to allocate $114 of contract revenue ($80/$700 x $1,000) and the $80 of costs incurred to yr1. Thus, application of the look-back method results in a net increase in taxable income for yr1 of $34.

**Step 2: Computation of hypothetical overpayment or underpayment of tax**

The second step is to compare what the tax liability would have been under the percentage of completion method as reapplied for each tax year for which the tax liability is affected by income from contracts completed or adjusted in the filing year (a "redetermination year") with the most recent determination of tax liability for that year to produce a hypothetical underpayments or overpayment of tax. After
redetermining the income tax liability for each tax year affected by the reallocation of contract income, the taxpayer then determines the amount, if any, of the hypothetical underpayment or overpayment of tax for each of these redetermination years. The hypothetical underpayment or overpayment for each affected year is the difference between the tax liability as redetermined under the look-back method for that year and the amount of tax liability determined as of the latest of the following:

a. The original return date;

b. The date of a subsequently amended or adjusted return (if, however, the amended return is due to a carryback described in section 6611(f), see paragraph (c)(4)(iii)); or,

c. The last previous application of the look-back method.

**Step 3: Calculation of interest on underpayment or overpayment**

The third step is to apply the rate of interest on overpayments designated under section 6621 of the Code, compounded daily, to the hypothetical underpayment or overpayment of tax for each redetermination year to compute interest that runs, generally, from the due date (determined without regard to extensions) of the return for the redetermination year to the due date (determined without regard to extensions) of the return for the filing year. This time period generally ends on the earlier of:

a. The due date (not including extensions) of the return for the filing year, and

b. The date both

   i. The income tax return for the filing year is filed, and

   ii. The tax for that year has been paid in full.

6. There is a simplified impact method that is an alternative.

7. Under the simplified marginal impact method, a taxpayer calculates the hypothetical underpayments or overpayments of tax for a prior year based on an assumed marginal tax rate.

8. Step 2 as stated earlier is modified as the hypothetical underpayment or overpayment of tax for each year of the contract (a "redetermination year") is determined by multiplying the applicable regular tax rate by the increase or decrease in regular taxable income from reallocating income under Step 1.

9. The applicable regular tax rate is the highest rate of tax in effect for the redetermination.

10. The simplified marginal impact method is required to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership, an S corporation, or a trust, and that is not closely held.
11. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at the entity level. For determining the amount of any hypothetical underpayment or overpayment, the applicable regular and alternative minimum tax rates, respectively, are generally the highest rates of tax in effect.

12. A pass-through entity is closely held if, at any time during any redetermination year, 50 percent of more (by value) of the beneficial interests in that entity are held (directly or indirectly) by or for 5 or fewer persons.

13. Form 8867 is required to be filed with respect to the look back method.

VII. Repairs and Capitalization

A. Safe Harbor Rule

1. The tangible property rags include the de minimis expensing safe harbor. The safe harbor is designed to allow taxpayers to annually elect to deduct the cost of materials and supplies in units of property produced or acquired subject to the per item dollar limit. (Reg. Sec. 1.263 (a)-1 (f)).

2. The maximum per item de minimis safe harbor limit was increased from $500-$2500 for taxpayers that do not have an applicable financial statement (AFS). This was effective for tax years beginning on or after January 1, 2016. (See Notice 2015-82, 2015-50 IRB; IR 2015-133).

3. The maximum per item safe harbor for taxpayers with an applicable financial statement (AFS) remains at $5000.

4. The de minimis safe harbor is determined at the invoice or item level.

5. A taxpayer electing to apply the de minimis safe harbor is not required to include in the cost of the tangible property the additional costs of acquiring or producing such property if these costs are not included in the same invoice as the tangible property. However, the taxpayer must include, in the cost of such property, all additional costs (for example, delivery fees, installation services, or similar costs) if these additional costs are included on the same invoice with the tangible property.

6. If the invoice includes amounts paid for multiple tangible properties and such invoice includes additional invoice costs related to these multiple properties, then the taxpayer must allocate the additional invoice costs to each property using a reasonable method.

7. Reasonable allocation methods include, but are not limited to, specific identification, a pro rata allocation, or a weighted average method based on the property's relative cost (§1.263(a)-1(f)(3)).

Since taxpayers are limited to a $200 de minimis amount when deducting
materials and supplies, taxpayers who wish to apply the de minimis rule to any material or supply costing more than $200 may elect to use the repair vs improvement de minimis safe harbor rules. (§1.2623(a)-1(f)(3)(ii)).

8. In general, when you elect the de minimis safe harbor, materials and supplies that also qualify under your de minimis safe harbor are treated as de minimis costs and are not treated as materials and supplies. However, the de minimis safe harbor doesn't change your ability to deduct costs for materials and supplies, incidental or non-incidental, that don't qualify under the de minimis safe harbor.

9. Similarly, the de minimis safe harbor doesn't change your ability to deduct repair and maintenance costs that don't qualify under the de minimis safe harbor, for example, costs that exceed the safe harbor threshold. Therefore, for costs that don't qualify under the de minimis safe harbor, you apply the general rules for identifying and deducting repair and maintenance costs, incidental supplies, and non-incidental materials and supplies.

10. Inventory that you are accounting for as non-incidental materials and supplies under Revenue Procedure 2001-10 or Revenue Procedure 2002-28 are still characterized as inventory and not subject to the de minimis safe harbor election. These two revenue procedures allow qualifying small business taxpayers to remain on the cash method even though they have inventory and to account for their inventory as non-incidental materials and supplies.

B. Applicable Financial Statement

1. An applicable financial statement for purposes of qualifying for the de minimis rule only includes:

a. A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10-K or the Annual Statement to Shareholders);

b. A certified audited financial statement that is accompanied by the report of an independent CPA (or in the case of a foreign entity, by the report of a similarly qualified independent professional) that is used for (a) credit purposes, (b) reporting to shareholders, partners, or similar persons, or (c) any other substantial non-tax purpose.

c. In addition, the entities with an AFS must have established at the beginning of the tax year, written accounting procedures expensing, for non-tax purposes, de minimis items costing less than a certain dollar amount or with an economic life of 12 months or less.

d. If the taxpayer's financial results are reported on the AFS for a group of entities, the group's AFS may be treated as the AFS of the taxpayer. Also, the written accounting procedures provided for the group and utilized for the group's AFS may be treated as the written accounting procedures of the taxpayer.
C. Accounting Policy

1. Taxpayers that are required to have an applicable financial statement must also have a written accounting policy implementing the safe harbor provision.

2. Although the language of the regulations seems to indicate that taxpayers without an applicable financial statement are not required to have a written accounting policy implementing the safe harbor, an unwritten policy employee, the $2500 per item limit must still be in effect as of the beginning of 2016 in order for the limit to apply to the 2016 tax year.

3. The per item deduction limit cannot exceed the $2500 limit but only items costing $2500 or less receive the protection of the safe harbor.

4. For each tax year beginning after 2016, an unwritten policy with a $2500 per item limit must be in effect as of the beginning of that tax year in order for the higher limit to apply. It seems logical from a conservative tax perspective that taxpayers with no applicable financial statement, may wish to incorporate a written policy.

5. For tax years before January 1, 2016, the service will allow a taxpayer without the applicable financial statement to qualify for $2500 limit. If all of the requirements for the safe harbor were met. Likewise, if the taxpayer had taken a deduction limit in excess of the old $500 safe harbor provision items that cost no more than the limit set will receive safe harbor protection. The Service will not challenge deductions within the $2500 limit in an audit assuming the taxpayer otherwise meets the safe harbor requirements.

D. Safe Harbor Election

1. Tax preparers should attach a statement titled "Section 1.263(a)-1(f) de minimis safe harbor election" to the timely filed original federal tax return including extensions for the taxable year in which the de minimis amounts are paid.

2. The statement should include your name, address, and Taxpayer Identification Number, as well as a statement that you are making the de minimis safe harbor election.

3. Under the election, you must apply the de minimis safe harbor to all expenditures meeting the criteria for the election in the taxable year.

4. An annual election is not a change in method of accounting. Therefore, tax preparers should not file Form 3115, Application for Change in Method of Accounting, to use the de minimis safe harbor for a particular tax year, and should not file a Form 3115 to change the amount you deduct under your book policy.

5. Similarly, you should not file a Form 3115 to stop applying the de minimis safe harbor for a subsequent tax year.
E. Recordkeeping

1. These regulations do not impose any specific record-keeping requirements for the use of the identifying and disgusted with the shift deminimis safe harbor. However, under §6001, taxpayers are required to keep books and records sufficient to establish their eligibility to use the deminimis safe harbor.

2. Specifically, taxpayers must maintain books and records reasonably sufficient to determine:

   - The total amounts paid and deducted as materials and supplies;
   - The total amounts paid and not capitalized;
   - The computation of the de minimis amount;
   - That income has not been distorted by the aggregate of the deductions if the aggregate amount exceeds the de minimis amount; and
   - That the regulations requirements have been met (§6001).

F. Materials and Supplies Defined

1. A material and supply is defined to mean tangible property used or consumed in the taxpayer's business operations that is not inventory and that is (See Reg. §1.162-3(c)):

   a. A component acquired to maintain, repair, or improve a unit of tangible property owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property;

   b. Fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less, beginning when used in a taxpayer's operations;

   c. A unit of property that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations;

   d. A unit of property that has an acquisition cost or production cost of $200 or less (the $200 limit may be increased by the IRS); and

   e. Property identified in published guidance in the Federal Register or in the Internal Revenue Bulletin as materials and supplies.

2. The property in question needs only fit into one of the above categories to qualify as a material or supply.

3. A taxpayer may deduct the cost of incidental and non-incidental materials and supplies in the following fashion:
• **Incidental materials and supplies** - If the materials and supplies are incidental, i.e., of minor or secondary importance, carried on hand without keeping a record of consumption, and no beginning and ending inventories are recorded, e.g., pens, paper, staplers, toner, trash baskets, then you deduct the materials and supplies costs in the taxable year in which the amounts are paid or incurred, provided taxable income is clearly reflected.

• **Non-incidental materials and supplies** - If the materials and supplies are not incidental, then you deduct the materials and supplies costs in the taxable year in which the materials and supplies are first used or consumed in your operations.

For example, deduct certain expendable spare parts in a trucking business for which records of consumption are kept and inventories are recorded in the taxable year the part is removed from your storage area and installed in one of your trucks. However, an otherwise deductible material or supply cost could be subject to capitalization under § 263(a) if you use the material or supply to improve property or under § 263A if you incorporate the material or supply into property you produce or acquire for resale.

4. Hence, the taxpayer based on a facts and circumstances assessment determines whether the materials and supplies are incidental or non-incidental in nature.

5. If the taxpayer elects to use the de minimis safe harbor and any materials and supplies also qualify for the safe harbor, you must deduct amounts paid for these materials or supplies under the safe harbor in the taxable year the amounts are paid or incurred. Such amounts are not treated as amounts paid for materials and supplies and may be deducted as business expenses in the taxable year they are paid or incurred.

**G. Rotable Parts**

1. A rotatable spare part are considered materials and supplies. It is a component of a unit of property which is installed on the property, removed from the property, repaired or improved, and either reinstalled on the same or other property or stored for later installation. Temporary spare parts are components used temporarily until a new or repaired part can be installed and then are removed and stored for later (emergency or temporary) installation (See Reg. §1.162-3(c)(2)).

2. Rotable and temporary spare parts are considered used or consumed in the tax year in which the parts are disposed of. Therefore, they are deducted in the disposition year (See Reg.§1.162-3(a)(3)).
Example

AggieCo operates a fleet of vehicles used in its service business. Whenever the company acquires a new type of vehicle, it also acquires a substantial number of rotable spare parts to replace quickly similar parts in its vehicles as those parts break down or wear out. These rotable parts are removable from the vehicles and are repaired so that they can be reinstalled on the same or similar vehicles.

In 2014 the company acquires several vehicles and a number of rotable spare parts.

In 2015, they repairs several vehicles by using these rotable spare parts.

In 2016, they removes these rotable spare parts from its vehicles, repairs the parts, and reinstall them on other similar vehicles.

In 2018, they can no longer use the rotable parts it acquired in 2014 and disposes of them as scrap. The amounts that the Company paid for the rotable spare parts in 2014 are deductible in 2018, the taxable year in which they dispose of the parts (§1.162-3(h), Exp. 2).

3. Optional Method Defined - §1.162-3(e)).

a. Taxpayers may use an optional method to account for rotable and temporary spare parts. If the optional method is used, taxpayers must use it for all of its pools of rotable and temporary spare parts used in the same trade or business and for which it uses this method for its books and records.

b. The optional method is a method of accounting under §446(a).

c. Under the optional method, taxpayers must deduct the amount paid to acquire or produce the part in the taxable year that the part is first installed on a unit of property for use in the taxpayer’s operations.

d. When the part is removed from a unit of property to which it was installed, taxpayers:

  • Must include in gross income the fair market value of the part.
  • Must include in the basis of the part the fair market value of the part included in income and the amount paid to remove the part from the unit of property.
  • May not currently deduct and must include in the basis of the part any amounts paid to maintain, repair, or improve the part in the taxable year these amounts are paid.
  • Must deduct the amounts paid to reinstall the part and those amounts included in the basis of the part in the taxable year that the part is reinstalled on a unit of property.
  • Must deduct the amounts included in the basis of the part in the taxable year in which the part is disposed of by the taxpayer.

e. No formal election is required to use the optional method.
Example

Assume the same facts as above, except X uses the optional method of accounting for all its rotatable and temporary spare parts.

In Year 1, X acquires several vehicles and a number of rotatable spare parts (the "Year 1 rotables") to be used as replacement parts in these vehicles.

In Year 2, X repairs several vehicles and uses the Year 1 rotables to replace worn or damaged parts.

In Year 3, X pays amounts to remove these Year 1 rotables from its vehicles. In Year 4, X pays amounts to maintain, repair, or improve the Year 1 rotables.

In Year 5, X pays amounts to reinstall the Year 1 rotables on other similar vehicles.

In Year 8, X removes the Year 1 rotables from these vehicles and stores these parts for possible later use.

In Year 9, X disposes of the Year 1 rotables.

X must deduct the amounts paid to acquire and install the Year 1 rotables in Year 2, the taxable year in which the rotatable spare parts are first installed by X in X's vehicles.

In Year 3, when X removes the Year 1 rotables from its vehicles, X must include in its gross income the fair market value of each part. Also, in Year 3, X must include in the basis of each Year 1 rotatable the fair market value of the rotatable and the amount paid to remove the rotatable from the vehicle.

In Year 4, X must include in the basis of each Year 1 rotatable the amounts paid to maintain, repair, or improve each rotatable. In Year 5, the year that X reinstalls the Year 1 rotables (as repaired or improved) in other vehicles, X must deduct the installation costs and the amounts previously included in the basis of each part.

In Year 8, the year that X removes the Year 1 rotables from the vehicles, X must include in income the fair market value of each rotatable part removed. In addition, in Year 8, X must include in the basis of each part the fair market value of that part and the amount paid to remove the each rotatable from the vehicle.

In Year 9, the year that X disposes of the Year 1 rotables, X may deduct the amounts remaining in the basis of each rotatable.

H. Election to Capitalize Materials and Supplies

1. In general, the determination of whether a cost is for repair or improvement under these rates we based on a facts and circumstances examination. The facts and circumstance analysis is described in greater detail herein. There is an exception to the facts and circumstance that allows for an election to capitalize materials and
supplies.

2. The final regulations contain a provision that allows for an election to capitalize repair and maintenance expenses as improvements if the taxpayer treats such costs as capital expenditures for financial accounting purposes.

3. A taxpayer may elect to capitalize the cost of a material or supply in the tax year the cost is paid or incurred and depreciate the cost in the tax year it is placed in service (See Reg. §1.162-3(d)). Any asset for which the election is made is not treated as a material or supply.

4. Note that the election would be useful to taxpayers who may be unsure of the proper tax year of deduction because they are unable to distinguish between incidental and non-incidental supplies or do not maintain detailed records regarding their purchases and the tax year in which they are used or consumed.

5. The election does not apply to a component of a material or supply unless the capitalization election is made for the entire material of supply.

6. The election does not apply to rotatable parts if the optional method is used.

7. A taxpayer makes the election to capitalize the cost of a material and supply by capitalizing the cost in the tax year the cost is paid or incurred and by depreciating the cost when the material and supply is placed in service. The election is made on a taxpayer's timely filed original Federal income tax return (including extensions) for the tax year the asset is placed in service for purposes of determining depreciation.

8. The election is made by attaching a statement to the timely filed federal tax return, including extensions. The statement would include the name, address and tax identification number, and a statement describing this election.

I. Amounts Paid to Acquire or Produce Tangible Property -Reg. Section 1.263(a)-2

1. The regulations include rules explaining the types of costs that must be capitalized as amounts paid to acquire or produce a unit of tangible property (See Reg. §1.263(a)-2). The final regulations relating to amounts paid to acquire or produce a unit of property are generally effective for tax years beginning on or after January 1, 2014 (See Reg. §1.263(a)-2(k)).

2. A taxpayer must capitalize amounts paid or incurred to acquire or produce a "unit" of real or personal property, including leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. The term "produce" is defined in the same way as for purposes of the uniform capitalization rules. Amounts paid or incurred to acquire or produce a unit of property include (See Reg. §1.263(a)-2(d)(1)):

- Invoice price;
- Transaction costs; and
• Costs for work performed prior to the actual date that the unit of property is placed in service. The placed-in-service date is the actual date the property is placed in service and not the date placed in service under the applicable MACRS depreciation convention.

3. Capitalized costs paid to acquire or produce a unit of real or personal property include the costs for work performed prior to the date that the unit of property is placed in service. Work performed includes, for example, repairs, installation costs, and testing costs (See Reg. 1.263(a)-2(d)(1)).

J. Facilitative Acquisition Costs

1. If it is determined based on a facts and circumstances that an amount is paid or incurred in the process of investigating or otherwise pursuing the acquisition or production of real or personal property such amount is considered paid or incurred to facilitate the acquisition and is a capitalized transaction cost that is included in the basis of the property acquired or produced (See Reg. §1.263(a)-2(f)(1)).

2. An amount is paid or incurred to facilitate the acquisition of real or personal property if the amount is paid or incurred in the process of investigating or otherwise pursuing the acquisition. Whether an amount is paid or incurred in the process of investigating or otherwise pursuing the acquisition is determined based on all of the facts and circumstances. (See Reg. §1.263(a)-2(f)(2)(i)).

3. Per the regulations, the following are examples of costs that are "inherently facilitative" and, therefore, must be capitalized (See Reg. §1.263(a)-2(f)(2)(ii)):

• Transporting the property (for example, shipping fees and moving costs);
• Securing an appraisal or determining the value or price of property;
• Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;
• Application fees, bidding costs, or similar expenses;
• Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract, or purchase agreement);
• Examining and evaluating the title of property;
• Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees;
• Conveying property between the parties, including sales and transfer taxes, and title registration costs;
• Finders' fees or brokers' commissions, including amounts paid or incurred that are contingent on the successful closing of the acquisition;
• Architectural, geological engineering, environmental, or inspection services pertaining to particular properties; and
• Services provided by a qualified intermediary or other facilitator of a like-kind exchange.

4. Inherently facilitative costs for both real and personal property must be
capitalized, even if the property is not acquired or produced; these costs are deductible when the acquisition is abandoned.

5. Inherently facilitative amounts allocable to real and personal property not acquired may be allocated to those properties and recovered as appropriate.

6. The regulations do not require the allocation of inherently facilitative amounts to properties that are not acquired.

7. Taxpayers may allocate these amounts to the property which is actually acquired in accordance with the rule which was followed prior to the temporary regulations (See United Dairy Farmers, Inc., CA-6, 2001-2 USTC ,J50, 680, 267 F.3d 510; Nicolazzi v. Commissioner , 79 T.C. 109, Dec. 39,200; affd, CA-6, 83-2 USTC 83-2 USTC ,J9743, 722 F.2d 324).

Example

A taxpayer acquires a building in which to relocate its offices. Prior to acquiring the building the taxpayer hired a broker to find property for the taxpayer to acquire. Upon the closing of the sale, the taxpayer paid the broker a commission. The taxpayer also hires a third party to perform a termite inspection and environmental survey of the building. The broker fees, termite inspection and environmental study are inherently facilitative costs and must be capitalized.

X decides to purchase a building in which to relocate its offices and hires a real estate broker to find a suitable building. X pays fees to the broker to find property for X to acquire. X must capitalize the amounts paid to the broker because these costs are inherently facilitative of the acquisition of real property.

X decides to purchase building A and pays amounts to third-party contractors for a termite inspection and an environmental survey of building AX must capitalize the amounts paid for the inspection and the survey of the building because these costs are inherently facilitative of the acquisition of real property.

X purchases all the assets of Y and, in connection with the purchase, hires a transportation company to move storage tanks from Y’s plant to X’s plant. X must capitalize the amount paid to move the storage tanks from Y’s plant to X's plant because this cost is inherently facilitative to the acquisition of personal property.

X owns several retail stores. X decides to examine the feasibility of opening a new store in city A. In October, Year 1, X hires and incurs costs for a development consulting firm to study city A and perform market surveys, evaluate zoning and environmental requirements, and make preliminary reports and recommendations as to areas that X should consider for purposes of locating a new store. In December, Year 1, X continues to consider whether to purchase real property in city A and which property to acquire. X hires, and incurs fees for, an appraiser to perform appraisals on two different sites to determine a fair offering price for each site.
In March, Year 2, X decides to acquire one of these two sites for the location of its new store. At the same time, X determines not to acquire the other site. X is not required to capitalize amounts paid to the development consultant in Year 1 because the amounts relate to activities performed in the process of determining whether to acquire real property and which real property to acquire and the amounts are not inherently facilitative costs. X must capitalize amounts paid to the appraiser in Year 1 because the appraisal costs are inherently facilitative costs.

In Year 2, X must include the appraisal costs allocable to property acquired in the basis of the property acquired and may recover the appraisal costs allocable to the property not acquired.

8. Pre-Decisional Costs for Real Property Are Deductible. An amount paid or incurred in the process of investigating or pursuing the acquisition of real property and which is not an inherently facilitative amount does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire. These are considered pre-decisional costs and they are deductible in the case of real property.

a. If personal and real property are acquired in the same transaction, a taxpayer may use a reasonable allocation method to allocate, between the personal property and real property, the costs of determining whether to enter the acquisition transaction and which property to acquire (See. Reg. §1.263(a)-2 (f)(2)(iii)).

b. This rule is also effective for amounts paid or incurred (to acquire or produce property) in tax years beginning on or after January 1, 2012 (See. Reg. §1.263(a)- 2 (k)).

Example

X owns a parcel of real estate. X sells the real estate and pays legal fees, recording fees, and sales commissions to facilitate the sale. X must capitalize the fees and commissions and, in the taxable year of the sale, offset the fees and commissions against the amount realized from the sale of the real estate.

Now assume the same facts except that X is a dealer in real estate. The commissions and fees paid to facilitate the sale of the real estate are treated as ordinary and necessary business expenses under section 162.

K. Capitalization of Improvements

1. The regulations require capitalization of amounts paid to improve a unit of tangible property.

2. A unit of property is improved if amounts are paid for activities performed after the unit of property is placed in service by the taxpayer resulting in:

   • A betterment to the unit of property;
   • A restoration of the unit of property; or
• Adaptation of the unit of property to a new or different use. (See Reg. Section 1.263(a)-3 (d)).

3. A unit of property consists of a group of functionally interdependent components, such as the parts of a machine, with the machine being treated as a unit of property. In the case of a building, the building is a unit of property except that certain major systems of the building, such as heating, air conditioning, and ventilation, plumbing, and electrical, are treated as separate units of property (See Reg. §1.263(a)-3(e)).

4. Generally, the larger the unit of property is the more likely that work on that property will be considered a deductible repair.

   **Example**

   If the entire building is the unit of property, then major work on an HVAC system might be a repair. However, if the HVAC system is the unit of property, then that work will probably need to be capitalized.

5. A capitalized betterment is an expenditure that:

   • Ameliorates a material condition or defect that existed prior to the taxpayer's acquisition of the unit of property whether or not the taxpayer was aware of the condition or defect at the time of acquisition;
   • Results in a material addition (for example, physical enlargement, expansion, or extension) to the unit of property; or
   • Results in a material increase in capacity (including additional cubic or square space), productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property (See Reg. §1.263(a)-3(h)(1)).

6. Facts and circumstances taken into account in determining whether an expenditure results in a betterment include but are not limited to, the purpose of the expenditure, and the physical nature of the work performed, the effect of the expenditure on the unit of property, and the taxpayer's treatment of the expenditure on an applicable financial statement.

   **Example**

   ABC Corp. purchases a parcel of land without realizing that the soil was contaminated. The land is a the unit of property. ABC's remediation costs to remove the contaminants result in a capitalized betterment to the land because ABC incurs the costs to ameliorate a material condition or defect that existed prior to its acquisition of the land (See Reg. §1.263(a)-3 (h)(4), Ex 1).

7. The replacement of a part of a unit of property with an improved, but comparable part does not, by itself, result in a betterment to the unit of property if
it is not practical to replace the part with the same type of part (for example, because of technological advancements or product enhancements) (See Reg. §1.263(a)-3(h)(3)(ii)).

Example

A taxpayer replaces wooden shingles which are no longer available on the market with comparable asphalt shingles that are stronger than the wooden shingles. The replacement is not a betterment. However, the replacement with shingles made of lightweight composite materials that are maintenance-free and do not absorb moisture and have a 50-year warranty and a Class A fire rating is a betterment (See. Reg. §1.263(a)-3(h)(4), Exs. 14 and 15).

8. If a particular event triggers an expenditure, the determination of whether the expenditure results in a betterment is made by comparing the condition of the property immediately before the event with the condition of the property immediately after the expenditure (See. Reg. §1.263(a)-3(h)(3)(iii)(A) and (C)).

9. If the taxpayer has not previously corrected the effects of normal wear and tear, the comparison is made to the condition of the property when placed in service by the taxpayer (See. Reg. §1.263(a)-3(h)(3)(iii)(B)).

Example

Acme Veterinary Clinic replacing and reconfiguring a small number of display tables and racks to provide better exposure of the merchandise. In addition, the relocated lights, move a wall to accommodate the reconfiguration of tables and racks, repaint, patch holes in walls, replacing damaged floor and ceiling tiles and power washing building exteriors. The refresh is not a betterment because it does not result in material increases in capacity, productivity, efficiency, strength, or quality of the buildings' structures or any building systems as compared to the condition of the buildings' structures and systems after the previous refresh (See Reg. §1.263(a)-3(h)(4), Example (6)).

10. The Regulations contain numerous situational examples illustrating when, and when not, to capitalize an improvement -§1.263(a)-3(i)(3):

- Remediation costs to replace underground gasoline storage tanks unknown at time of purchase is a land improvement that must be capitalized (§1.263(a)-3(j)(3), Exp. 1).

- Cleanup of asbestos in existing building need not be capitalized (§1.263(a)-3(i)(3), Exp. 2).

- Expenditures made to fix a defect existing prior to purchase of a Zamboni, but the defect wasn't material under the facts and circumstances and can be deducted (§1.263(a)-3G)(3), Exp. 4).
• Repairing pre-existing conditions three years after acquisition must be capitalized as an improvement if aware of condition prior to acquisition (§1.263(a)-3(j)(3), Exp. 5).

• Building refreshment and limited improvements by nationwide chain of retail stores not an improvement (only kept buildings in efficient operating condition) (§1.263(a)-3(i)(3), Exp. 6, 7).

• Amounts paid by retailer to upgrade wiring and to remove and replace recess lighting throughout stores materially increased the productivity, efficiency, and quality of the stores' electrical systems. Amounts paid to remove and rebuild walls, replace ceilings, rebuild facades, replace doors, and to replace flooring materially increased the productivity, efficiency, and quality of store buildings’ structures (§1.263(a)-3(j)(3), Exp. 8).

• Relocating and reinstalling cash registers at another site is not an improvement (§1.263(a)-3(j)(3), Exp. 9).

• Relocating and reinstalling manufacturing equipment at another site resulting in increased capacity is an improvement that must be capitalized (§1.262-3(j)(3), Exp. 10).

• City requirement to earthquake-proof front of hotel by adding expansion bolts creates an improvement that must be capitalized; the new requirement that the hotel meet new safety standards to continue operating is not relevant (§1.263(a)-3(j)(4), Exp. 11).

• Maintenance expenses must be capitalized when incurred simultaneously with a material capacity increase. Harbor had a channel that was originally 20 feet deep, but erosion reduced depth to 18 feet. Bringing it back to 20 feet deep need not be capitalized. But, dredging channel to 25 feet is a material upgrade and 100% of the dredging costs must be capitalized; no proration is allowed. (§1.263(a)-3(i)(3), Exp. 15, 16, 17).

• Removing drop-ceiling and repainting original ceiling is not an improvement (§1.263(a)-3(i)(3), Exp. 18).

• Adding new insulation that reduces annual power costs by 50% is an improvement (§1.263(a)-3(j)(3), Exp. 21).

• Adding a second electrical panel with additional circuits and adding wiring and outlets throughout the building is an improvement (§1.263(a)-3(j)(3), Exp. 23).

• Replacing roof membrane is a repair, not an improvement (§1.263(a)-3(j)(3), Exp. 13).

11. Restorations are considered improvements that must be capitalized.
Other Examples

- Replacement of major component or substantial structural part of roof must be capitalized (§1.263(a)-3(k)(7), Exp. 14).
- Replacing one of three furnaces in the HVAC system is not an improvement, and the cost can be expensed (§1.263(a)-3(k)(7), Exp. 16).
- Replacing the only chiller in an HVAC system is an improvement and must be capitalized (§1.263(a)-3(k)(7), Exp. 17).
- Replacing three of the ten roof-mounted HVAC units is an expense (§1.263(a)-3(k)(7), Exp. 18).
- Replacing the entire sprinkler or electrical system is an improvement, but replacing 30% of the wiring is a repair (§1.263(a)-3(k)(7), Exp. 19, 20 & 21)
- Replacing all the toilets and sinks in retail building is an improvement and must be capitalized but replacing 8 of 20 sinks is a repair (§1.263(a)-3(k)(7), Exp. 22 & 23).
- Updating a hotel 2 floors at a time, or all floors over three years, is an improvement (§1.263(a)-3(k)(7), Exp. 24).
- Replacing 100 of 300 exterior windows is a repair unless the 300 windows comprise a significant portion of the building's exterior. But, replacing 200 of the 300 exterior windows is an improvement that must be capitalized (§1.263(a)-3(k)(7), Exp. 25, 26 & 27).
- Replacing wood flooring in the hotel lobby is not an improvement but replacing the floors in all the public areas is an improvement that must be capitalized (§1.263(a)-3(k)(7), Exp. 28 & 29).

12. The cost of replacing a major component or substantial structural part of a unit of property must be capitalized as a restoration (See Reg. §1.263(a)-3(i)(4)).

13. The determination is based on all the facts and circumstances, including the quantitative or qualitative significance of the part or combination of parts in relation to the unit of property.

14. A major component or substantial structural part includes a part or combination of parts that comprises a large portion of the physical structure of the unit of property, or performs a discrete and critical function in the operation of the unit of property.

15. An adaptation to a new or different use is a type of improvement that is capitalized (see Reg. §1.263(a)-3(j)).
16. In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time it was originally placed in service by the taxpayer.

Example

Acme Corp. owns the land that upon which its manufacturing plant is located. The company has decided to discontinue manufacturing operations at the site, and wants to sell the property to a real estate develop. The developer wants to use the land to construct custom home. However, he requires Acme to regrade the land so that it can be used for residential purposes. This adapts the land to a new or different use that is inconsistent with the company's current or prior use of the property at the time it was placed in service. As a result, the amount paid to regrade the land must be capitalized as an improvement (See Reg. §1.263(a)-3(j)(3), Ex 4).

Example

X owns a building consisting of twenty retail spaces. The space was designed to be reconfigured; that is, adjoining spaces could be combined into one space. One of the tenants expands its occupancy to include two adjoining retail spaces. To facilitate the new lease, X pays an amount to remove the walls between the three retail spaces. Assume that the walls between spaces are part of the building and its structural components.

If the amount paid adapts the buildings structure to a new or different use, X must treat the amount as an improvement to the building. The amount paid to convert three retail spaces into one larger space for an existing tenant does not adapt X's building structure to a new or different use because the combination of retail spaces is consistent with X's intended, ordinary use of the building structure. The amount paid by X to remove the walls does not improve the building.

I. Routine Maintenance Safe Harbor

1. The costs of performing certain routine maintenance activities are currently deductible under a routine maintenance safe harbor. Under the safe harbor, an amount paid is deductible if it is for ongoing activities that a taxpayer expects to perform as a result of the taxpayer's use of the unit of property to keep the unit of property in its ordinarily efficient operating condition.

2. The activities are routine only if, at the time the unit of property is placed in service, the taxpayer reasonably expects to perform the activities more than once during the class life of the unit of property (that is, during the recovery period prescribed for the MACRS alternative depreciation system (ADS)) (see Temporary Reg. §1.263(a)-3(g)).

3. The routine maintenance safe harbor does not apply to buildings or maintenance attributable to wear and tear that occurred on a used property prior to
acquisition by the taxpayer. The final regulations expand the routine maintenance safe harbor to allow expensing for routine maintenance activities on a building and its structural components (including building "systems"). However, an activity is covered only if the taxpayer reasonably expects to perform such maintenance more than once over a 10-year period.

4. Routine maintenance activities include:

- inspection,
- cleaning,
- testing of the unit of property,
- replacement of parts with comparable and commercially available and reasonable replacement parts.

5. Factors to be considered in determining whether a taxpayer is performing routine maintenance include:

- the recurring nature of the activity,
- industry practice,
- manufacturers' recommendations,
- the taxpayer's experience, and
- the taxpayer's treatment of the activity on its applicable financial statement.

M. Safe Harbor For Small Taxpayers With Buildings

1. The small taxpayer is not required to capitalize improvements if the total amount paid for repairs, maintenance, improvements and similar activities during the year that are performed on the building does not exceed the lesser of:

   - $10,000 or
   - 2 percent of the unadjusted basis of the building.

2. Amounts deducted under the de minimis rule or the new safe harbor for routine maintenance are counted toward the $10,000 limit. No amount is deductible under the safe harbor for buildings if this limit (or the $1 million adjusted basis limit) is exceeded. The safe harbor is applied separately to each building owned or leased by the taxpayer.

3. Eligible property includes a building (including structural components and building systems) owned or leased by a qualifying taxpayer and also portions of buildings that are owned or leased and considered separate units of property under the regulations, such as an individual condominium or cooperative unit or office space. The safe harbor does not apply to costs paid with respect to exterior land improvements that are separate units of property.

4. The election is made annually on a timely filed (including extensions) original income tax return. In the case of a partnership or S corporation that owns or leases a
building, the partnership or S corporation makes the election.

5. The election may not be made by filing an application for a change in accounting method or on an amended return unless permission to file a late election on an amended return is first obtained. The election is irrevocable.

Examples

Bob is a qualifying taxpayer who owns an office building in which he provides accounting services. In 2014, Bob's building has an unadjusted basis of $750,000, and he pays $5,500 for repairs, maintenance, improvements, and similar activities to the office building. Because Bob's building has an unadjusted basis of $1,000,000 or less it constitutes eligible building property. The $5,500 paid by Bob during 2014 for repairs, maintenance, etc. on his building does not exceed the lesser of $15,000 (2% of $750,000, the building's unadjusted basis) or $10,000. Bob may elect to immediately deduct amounts paid for repair, maintenance, etc. on the office building in 2014 (§1.263(a)-3(h)(10), Exp. 1).

Assume Betty's business with annual gross receipts under $10 million, Betty owns two multi-family rental properties, one in El Paso and one in San Antonio. In 2014, each property has an unadjusted basis of $300,000 (less than the $1,000,000 threshold). Betty pays $5,000 and $7,000 for improvements in 2014 on the El Paso and the San Antonio buildings, respectively. The $5,000 paid by Betty for improvements on the El Paso property does not exceed the lesser of $6,000 (2% of the building's $300,000 unadjusted basis) or $10,000. Betty may elect not to apply the capitalization rules and currently deduct the improvement amounts on her 2014 tax return. However, the $7,000 Betty spent to improve her San Antonio property exceeds $6,000, the lesser of the two limitations, and, therefore, she is not eligible to make the election for the San Antonio property. Instead, those property improvements must be capitalized and depreciated (§1.263(a)-3(h)(10), Exp. 3).

John, who makes under $10 million of gross receipts, leases retail space in a strip mall. The $4,000-per-month lease is a triple-net lease, and the lease term, with renewals, is 20 years. The unadjusted basis of John leased retail space is $960,000 ($4,000 monthly rent x 12 months x 20 years). Being under $1 million, the space is an eligible building under the safe harbor qualifications. In 2014, John pays $7,000 for repairs, maintenance, improvements, and similar activities performed on the space, which does not exceed the lesser of $19,200 (2% times $960000) or $10,000. Therefore, John may deduct the $7,000 without applying the repair vs improvement rules if he properly and timely makes the safe harbor election (§1.263(a)-3(h)(10), Exp. 4).

N. Unit of Property

1. The categorization of an expenditure as a capitalized improvement or a deductible repair is greatly affected by the size of the unit of property that is being worked on.

2. The "unit of property" is a critical concept in determining whether an
expenditure is a repair or capital expenditure. An expenditure on a large unit of
property is more likely to be considered a repair expense.

3. Generally, all the components that are functionally interdependent comprise a
single unit of property (that is, the placing in service of the component is dependent
upon the placing in service of the composite property) (§1.263(a)- 3(e)(1)). Special
rules exist for buildings, plant property, network assets, leased property (both buildings
and other than buildings), and improvements to property.

4. Additional rules apply if a taxpayer has assigned different MACRS classes or
depreciation methods to components of property or subsequently changes the class or
depreciation method of a component or other item of property. Property that is
aggregated and subject to a general asset account election or accounted for in a multiple
asset account (that is, pooled) may not be treated as a single unit of property.

5. Generally, the larger the unit of property is the more likely that costs will be
characterized as a repair rather than a capital expenditure under the new regulations.

6. Audit Guidelines

Tests for determining whether an expense is deducted or capitalized are generally applied
with respect to a particular unit of property. The ATG is equivocal as to the appropriate
unit of property definition to be applied in any particular case. While it does address the
unit of property in the context of buildings, it does not ultimately instruct examiners to go
in one particular direction; rather, it points out the inconsistency of the courts on this issue
under present law. The ATG recommends and discusses that "each taxpayer's facts and
circumstances must be analyzed closely to determine the appropriate [unit of property]
for a building or its structural components." Therefore, taxpayers will continue to be able
to assert on examination of their repair studies that the building is a single unit of property
under present law. Apart from buildings, the ATG provides seven factors to be considered
when determining the appropriate unit of property. These factors may offer some level of
insight for taxpayers when deciding whether their specific building or other tangible
property is a single unit of property or whether it must be broken down into further
units of property. The seven factors to consider, as set forth in the ATG, are:

• Whether the property is manufactured, marketed, or purchased separately;

• Whether the property is treated as a separate unit by a regulatory agency, in
industry practice, or by the taxpayer in its books and records;

• Whether the property is designed to be easily removed from a larger assembly,
is regularly or periodically replaced, or is one of a fungible set of interchangeable
or rotatable assets;

• Whether the property must be removed from a larger assembly to be fixed or
improved;

• Whether the property has a different economic life than the larger
assembly;

• Whether the property is subject to a separate warranty; and

• Whether the property serves a discrete purpose or functions independently from a larger assembly.

7. Each building system listed below is treated as a separate unit of property. The building structure consisting of the shell and all other structural components that are not part of a building system are treated as a separate unit of property.

8. A cost is treated as a capital expenditure if it results in an improvement to the building structure or to any of the specifically enumerated building systems. The building structure is defined as the building (as defined in §1.48-l(e)(l)) and its structural components (as defined in §1.48-l(e)(2)) other than the components specifically enumerated as building systems.

9. The building systems treated as separate units of property are (See Reg. 1.263(a)-3T(e)(2)(ii)):

• Heating, ventilation, and air conditioning ("HVAC") systems (including motors, compressors, boilers, furnace, chillers, pipes, ducts, radiators);

• Plumbing systems (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures);

• Electrical systems (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from property line to and between buildings and other permanent structures);

• All escalators and elevators;

• Fire-protection and alarm systems (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and firefighting equipment, such as extinguishers, hoses);

• Security systems for the protection of the building and its occupants (including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit);
• Gas distribution systems (including associated pipes and equipment used to distribute gas to and from property line and between buildings or permanent structures); and

• Other structural components identified in future published guidance that are specifically designated as building systems

In essence, the regulations treated each building and all of its structural components as a single unit of property. Building systems were not treated as separate units of property.

10. A lessee must capitalize the amount it pays to improve a unit of leased property, except to the extent that §110 applies to a construction allowance received by the lessee for the purpose of such improvement or where the improvement constitutes a substitute for rent.

11. A lessee's improvement that involves the acquisition or production of a new and distinct interest in property different from the underlying leased property, amounts paid for a lessee improvement are treated as the acquisition or production of a new unit of property rather than an improvement to the underlying property.

12. The lessee's reference for determining whether its expenditures are repairs or improvements is limited to the portion of the building structure and building systems actually located on the portion of the building that is leased.

Example

A lessee of an office space in a large building remodels the bathroom in the office. The expenditure is likely a capital improvement because work was done on a major portion of the plumbing system located within the office space. However, if the lessor performed the same work, it might be considered a repair because the work only affected a small amount of the building's entire plumbing system.

O. Section 179

1. The Section 179 Expense for 2016 has a maximum deduction of $500,000 with maximum annual qualifying property before phase-out of $2,010,000. This provision was made permanent going forward and adjusted annually for inflation. For 2016, air conditioning and heating units now qualify as separate units of property for Section 179.

   a. The provision regarding air conditioning and heating units does not apply to portable units.

   b. Hotels and motels that provide lodging on a transient basis cannot take advantage of repair work done on air conditioning or heating under this provision. In other words, they are barred from taking 179, they are not barred from taking bonus depreciation.
2. The Section 179 Deduction for Qualified Real Estate was made permanent by PATH Act. This provision under Section 179 (f), extend the definition of qualifying property to include qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

3. The PATH Act removed the $250,000 limitation related to the amount of 179 property that may be attributable to qualified real property for taxable years beginning after 2015. Further, for taxable years beginning after 2015, the provision strikes the flush language in §179(d)(l) that excludes air conditioning and heating units from the definition of qualifying property.

4. The 15 year depreciable life on certain real property improvements was also made permanent by the PATH Act. For purposes of this provision, qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease by either the lessee (or sublessee) or by the lessor of that portion of the building to be occupied exclusively by the lessee (or sublessee).

5. The improvement must be placed in service more than three years after the date the building was first placed in service. In addition, this provision applies to qualified restaurant property, which is any 1250 property that is a building or an improvement to a building, if more than 50% of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals.

6. Qualified restaurant property is recovered using the straight-line method and a half-year convention. It should also be noted this provision applies to qualified retail improvement property which is any improvement to an interior portion of a building that is nonresidential real property if such portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. It does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

7. In addition to the above, the following provisions related to Section 179 were made permanent:

   a. Expensing of off-the-shelf computer software is allowed.
   b. Allowing taxpayers to file amended returns without seeking IRS permission to make, revoke, or change a 179 deduction is allowed.
   c. The expensing deduction for qualified real property which was previously $250,000 has now been incorporated to the overall $500,000 provision
P. Bonus Depreciation

1. Bonus Depreciation was extended with phaseout's through 2019 by the PATH Act. Specifically, the current 50% bonus depreciation is in effect until the end of 2017. In 2018 it will be reduced to 40% and in 2019 you will be reduced to 30%.

2. Bonus depreciation will expire after 2019 under the present provisions.

3. The luxury auto limitation amount allowing for bonus depreciation will remain at $8000 until 2018 at which time it will be reduced to $6400 and then to $4800 in 2019.

4. Bonus Depreciation has also been extended to certain plants bearing fruits and nuts that are either planted or grafted beginning after December 31, 2015 and before January 1, 2020.

5. In addition, bonus depreciation was extended for property placed in service on or after January 1, 2016 to qualified improvement property.

6. Qualified Improvement property replaces the qualified leasehold improvement property category of bonus depreciation.

8. Qualified improvement property is defined as any improvement to the interior portion of a building that is not residential real property if the improvement is placed in service after the date the building was first placed in service (Section 168 (k) (3), as amended by the Path Act.

7. The phrase "first placed in service" means that the improvement can qualify for the building was first placed in service by any person.

Example

A taxpayer buys a building, in existing building that was previously placed in service by another party. Qualified improvements were made by the taxpayer prior to the date the taxpayer replaces the building in service. These improvements can qualify for bonus depreciation as long as the improvements were placed in service on or after Jerry one, 2016. The improvements would generally be considered placed in service when the taxpayer replaces the building service.

8. Qualified improvement property does not include expenditures attributable to the enlargement of a building, any elevators, escalators, or the internal structural framework of the building.

9. Qualified leasehold improvement property was defined. Similarly to qualified improvement property, except the following additional limits apply:

- the improvement needed to be made pursuant to the terms of the lease by the lessor or the lessee and the lessee must occupy the building;
- the improvement needed to be placed in service more than three years after
the building was first placed in service by any person; and
• improvements that were structural components benefiting a common area of
  the building do not qualify for bonus depreciation.

10. Effective for "specified plants" that are planted or grafted, a taxpayer engage in a
    farming business may elect to claim bonus depreciation under the rules. This again is
    effective on or after January 1, 2016. A specified plant is:

    • Any tree or find that bears fruit or nuts; and
    • Any other plant that will have more than one yield of fruit or nuts and that
      generally have at which the plant begins bearing fruit or nuts.

11. The bonus depreciation taken does reduce the adjusted basis of the specified
    plant. A depreciable tree, buying or plant is considered placed in service in the year it
    becomes productive. That means bears it must fruit in a commercial quantity sense.

12. To take the bonus depreciation for specified plants requires an annual election.
    The election, once made, cannot be revoked. The 50% will be reduced for specified
    plants planted or grafted in 2018 to 40%, and in 2019 to 30%.

13. The PATH Act stands the election for corporations to forgo bonus depreciation
    and claim unused AMT credit for four years. It applies to property placed in service
    through 2019. Beginning in 2016, the election is made annually in the amount of the
    unused credits that may be claimed is no longer subject to the annual limitation of $30
    million or 6% of unused AMT credit.

14. If the election is made, the limitation on the amount of the unused AMT credit that
    may be claimed in the tax year continues to be increased by the bonus depreciation
    amount for all assets placed in serviced during the year.

15. The bonus depreciation map for each asset placed in service in the tax year is
    equal to 20% of the difference between the first year depreciation (including any
    bonus depreciation taken) that could be claimed on the asset and the first year
    depreciation that could be claimed on the asset, if bonus depreciation was not
    claimed. In other words, a difference between bonus depreciation taken and not taken

16. The maximum increase amount limitation on the bonus depreciation amount is
    removed effective for years ending after 2015. Under this limitation, the bonus
    amount could not exceed the lesser of 30 Main dollars or 6%. The taxpayers’ unused
    AMT credits attributable to years beginning before 2006.

17. This massive increase is replaced with a new limitation on the bonus
    depreciation. Under this new limitation, the bonus depreciation amount computed for
    tax year cannot exceed the lesser of 50% of the corporations minimum tax credit for
    the corporations first year ending after 2015 or the minimum tax credit for the tax
    year determined by taking the Only the adjusted net minimum tax for tax years
    ending before January 1, 2016 determined by treating credits as allowed only first in
    first out basis.